Macedonia

Full Rating Report

Ratings

Foreign Currency

Long-Term IDR	BB+
Short-Term IDR	B

Local Currency

Long-Term IDR	BB+
Country Ceiling	BBB−

Outlooks

Long-Term Foreign-Currency IDR	Stable
Long-Term Local-Currency Rating	Stable

Financial Data

Macedonia

	2010
GDP	9.1
GDP per head (USD 000)	4.5
Population (m)	2
International reserves	2.3
Net external debt (% GDP)	23.9
Central government total debt (% GDP)	24.6
CG foreign-currency debt	1.8
CG domestically issued debt (MKDbn)	32.8

Related Research

Sovereign Review and Outlook (June 2011)
Global Economic Outlook (October 2011)

Analysts

Matteo Napolitano
+44 20 3530 1189
matteo.napolitano@fitchratings.com

Chris Pryce
+44 20 3530 1092
chris.pryce@fitchratings.com

Key Rating Drivers

Rating Affirmation: Fitch Ratings has affirmed Macedonia's Long-Term Foreign-Currency and Local-Currency IDRs at 'BB+' with a Stable Outlook. The rating is supported by strong macroeconomic policies, low government debt and deficits and a stable banking sector. However, fiscal vulnerabilities persist and currently constrain Macedonia's rating.

Strong Policy Framework: In 2011, Fitch expects the government to meet, or only just breach, its target of keeping the deficit to 2.5% of GDP. Given the government's strong track record, Fitch expects it to meet its targets of reducing the deficit to about 2% of GDP by 2013, and keeping public debt under 30% of GDP. The authorities' strong commitment to the Macedonian denar's (MKD) informal peg to the euro reinforces the importance of fiscal discipline.

Economic Performance Is Good: The agency expects growth to slow to 3.5% in 2012 from 3.8% in 2011, as economic activity declines in Macedonia's main trade partners. New export capacity in 2013 should allow it to take advantage of an expected upturn in the euro area, with domestic growth picking up to 4%. However, structural impediments to higher growth are likely to persist. The current-account deficit (CAD) is expected to rise in 2012-13, but should peak well below the 2008 level, when it was nearly 13% of GDP.

Some Vulnerabilities Persist: The government's decision in March 2011 to draw down nearly half of the SDR413m precautionary credit line (PCL) denotes financing problems, and illustrates the government's limited domestic financing options.

Solid Banking Sector: The banking system has retained a low risk profile, particularly in comparison with regional peers. The funding structure of banks is balanced, with a loan/deposit ratio of 89% at the end of Q211. However, an escalation in the Greek crisis could prompt the Macedonian authorities to act to prevent any loss of confidence in Greek bank subsidiaries.

Political Obstacles Remain: Political risks remain a constraint on the rating. Progress towards EU and NATO accession is still blocked by the dispute with Greece over Macedonia's constitutional name. Given the intransigence of both sides, Fitch deems it unlikely that a mutually acceptable settlement will be found in the near term. The "name issue" will therefore block Macedonia's path towards joining western institutions.

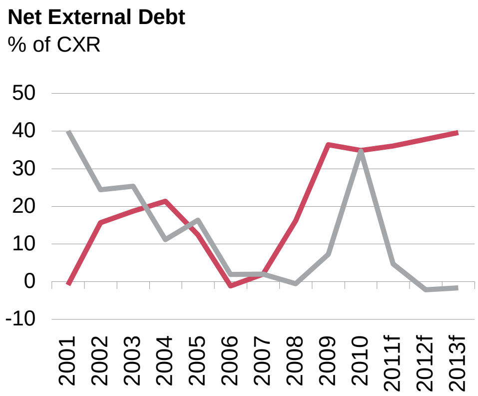
What Could Trigger a Rating Action

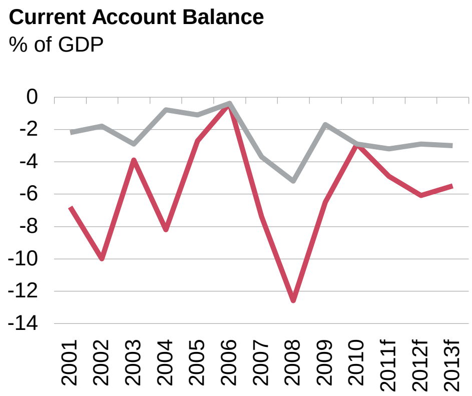
Deterioration in External Environment: Further intensification of the euro zone debt crisis could put downward pressure on Macedonia's ratings if it were to materially weaken Macedonia's external position. The government could then shelve plans to issue a Eurobond in 2012 and be compelled to make use of another portion of the PCL.

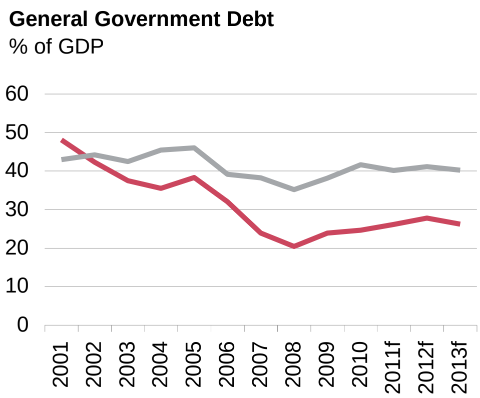
Continuing Sound Economic Policies: Commitment to sound economic policies in the medium term would lengthen Macedonia's impressive track record and attract further foreign investment. This could boost long-term economic growth and lead to an upgrade.

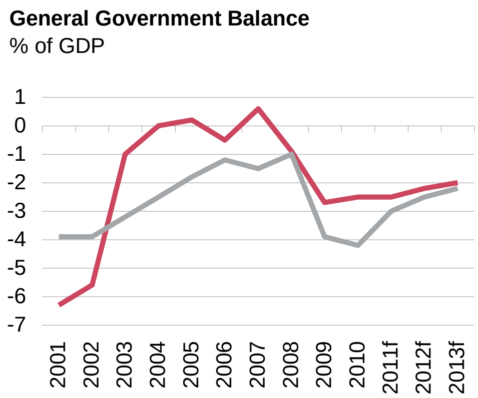
Resolution of "Name Dispute": The government's commitment towards EU and NATO integration could weaken if the "name dispute" drags on, heightening political risk. Conversely, resolution of the dispute would facilitate the path towards membership and could support a positive rating action, if other economic trends were favourable.

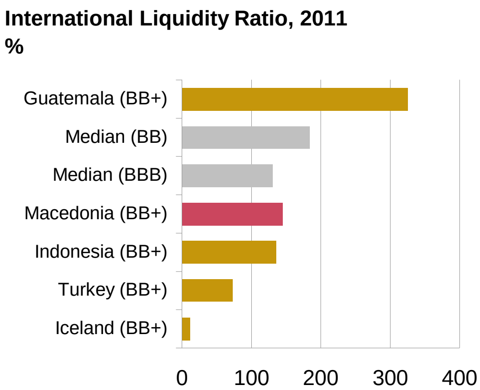
Peer Comparison

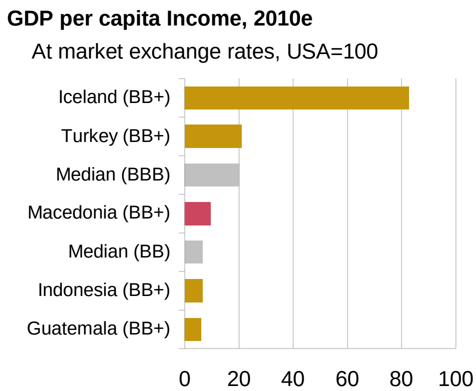












Macedonia

Medians

Related Criteria

Sovereign Rating Methodology (August 2011)

Peer Group

Rating	Country
BBB−	Azerbaijan
	Bulgaria
	Colombia
	Croatia
	Hungary
	India
	Kazakhstan
	Latvia
	Morocco
	Namibia
	Peru
	Portugal
	Romania
	Tunisia
BB+	**Macedonia**
	Costa Rica
	Guatemala
	Iceland
	Indonesia
	Philippines
	Turkey
	Uruguay
BB	Egypt
	El Salvador

Rating History

Date	Long-term foreign currency	Long-term local currency
13 Jun 06	BB+	BB+
01 Nov 05	BB	BB

Rating Factors

Summary: Strengths and Weaknesses

Rating factor	Macroeconomic	Public finances	External finances	Structural issues
Status	Neutral	Strength	Neutral	Neutral
Trend	Stable	Stable	Stable	Stable

Note: Relative to ‘BB’ category/sovereigns rated ‘BBB−’, ‘BB+’ and ‘BB’.
Source: Fitch

Strengths

- Macedonia benefits from a macroeconomic policy framework that is stable and well-managed. The authorities have shown consistently that they can meet agreed budget deficit targets, if necessary through additional spending restraint during the year.
- Commitment to the Macedonian denar’s informal peg to the euro, which has been in place since 1997 at MKD61.5:EUR1, is strong, and backed up by adequate foreign-exchange reserves (FXR).
- Macedonia ranks better than the ‘BB’ and ‘BBB’ medians on government debt metrics. The stock of general government debt is estimated at 25.8% in 2011, and debt/revenue at 80.7%.
- The banking sector is sound and well supervised. The system capital adequacy ratio (CAR) is double the legal minimum (8%) and non-performing ratios (NPLs) peaked in H210. The sector is funded locally and direct exposure to parent banks from ailing euro area countries is limited, despite the subsidiaries of Greek banks controlling a substantial market share.

Weaknesses

- The domestic debt market is under-developed. This was one of the reasons the government opted to draw down the PCL funds in March 2011 and constrains the sovereign’s financing flexibility.
- Unemployment remains high at 31% officially, although it is declining gradually. Most estimates put the actual rate at about 20%-25%. Higher rates of investment and economic growth are needed if structural unemployment is to decline.
- Recent FDI projects are promising, but more will be needed for Macedonia to reach its twin aims of reducing the structurally high (22% of GDP a year in 2006-10) trade deficit and diversifying the economy’s productive base.
- Despite some progress, EU accession remains distant as long as the ‘name issue’ between Macedonia and Greece remains unresolved, and other structural shortcomings are not addressed.

Local Currency Rating

Macedonia’s Local-Currency Long-Term IDR is ‘BB+’, the same as its Foreign-Currency Long-Term IDR. The central bank’s capacity to generate local currency without negative economic consequences is restricted by the fixed exchange-rate regime. The state is forced to obtain most of its funding from abroad, as a deep and liquid domestic market is unlikely to develop for some time.

Country Ceiling

Macedonia’s country ceiling of ‘BBB−‘ reflects reduced transfer and convertibility risk. EU accession aspirations and large current-account receipts from private transfers (including remittances sent home by Macedonians working abroad) are incentives for the government to maintain liberalised transfer and convertibility arrangements. Nevertheless, the presence of an informal currency peg limits the uplift of the Country Ceiling by one notch.

Outlook and Key Issues

CAD Increases, but External Finance Risks Look Manageable

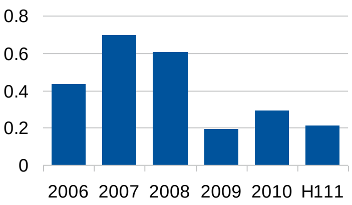
In the first half of 2011 the current-account deficit (CAD) doubled yoy to EUR264m. The deterioration was due to a larger trade deficit, which widened to EUR855m in H111 from EUR689m in H110. Imports grew strongly (31% yoy) as domestic demand recovered and energy prices picked up; however, exports were also buoyant, growing by 35% yoy, as Macedonia's small and open economy benefited from recovery in its main trading partners.

The other components of the current account registered yoy improvements or were stable in H111. In particular, there were substantial net inflows of EUR463m on the private transfers balance, which aggregates workers' remittances and conversions of 'mattress money' into and out of the Macedonian denar. This is considered an indicator of stress in the Macedonian financial system, as it gauges the confidence in the national currency, which has been informally pegged to the euro since 1997. Net FDI inflows of EUR151m covered 57% of the CAD, less than in 2010 (115%) but more than in crisis-stricken 2009 (31%).

Figure 1

Net FDI Flows

(USDm)



Source: NBRM, Fitch

At end-August 2011, official reserves covered over four months of expected imports of goods and services, or about 50% of broad money liabilities. At 145% for 2011, Fitch's wider measure of international liquidity (official reserves and banking system foreign liquidity over the sum of short-term external, interest payments on external debt, and non-resident holdings of domestic debt) is broadly in line with rating peers. However, it is lower than in 2010 when it was 159%. In light of the fixed exchange-rate regime and significant use of euros in the economy, higher reserves would still be desirable.

Figure 2

External Finances: Sources and Uses (USDbn)

	2010	2011f	2012f	2013f
Uses	0.71	0.92	1.25	1.42
Current account balance	0.26	0.53	0.71	0.70
MLT amortisation	0.45	0.39	0.54	0.73
Sovereign	0.05	0.12	0.15	0.40
Non-sovereign	0.40	0.27	0.39	0.33
Sources	0.71	0.92	1.25	1.42
Gross MLT borrowing	0.75	1.27	1.12	0.92
Sovereign	0.10	0.90	0.63	0.49
Non-sovereign	0.65	0.37	0.49	0.43
Net FDI	0.29	0.35	0.45	0.48
Net portfolio debt	-0.06	-0.01	0.35	0.08
Net portfolio equity	-0.02	-0.02	-0.03	-0.03
Other credit flows nes	-0.20	-0.16	-0.05	-0.02
Net E&O	0.00	0.00	0.00	0.00
Change in fx reserves	-0.05	-0.52	-0.60	0.00

Source: Fitch

Use of PCL Funds Denotes Lingering Vulnerabilities

At the end of 2010 the Macedonian government applied for a Precautionary Credit Line (PCL) from the IMF. The Fund introduced the PCL in August 2010 for countries with sound policy fundamentals and without immediate balance-of-payments needs, but which are still characterised by 'moderate vulnerabilities'. The IMF deemed that Macedonia met these criteria, and in January 2011 it approved a two-year PCL worth a cumulative SDR413m (EUR476m, USD647m at mid-October 2011 exchange rates).

At the time of the announcement, both the Fund and the authorities stated their expectation that the PCL would not be drawn down. Rather, the PCL would serve as a signal to economic agents that the IMF stood behind Macedonia in case turmoil made market-based financing impossible and put stress on the balance of payments and international reserves.

However, on 30 March 2011, the government purchased SDR197m under the PCL, thus abandoning the previously mooted option of issuing a Eurobond. According to the government, the purchase was necessary because of adverse factors that impeded access to market-based financing at attractive interest rates, despite favourable market conditions. Chief among these was an early general election, which created a climate of uncertainty that was not conducive to Eurobond issuance.

The decision to draw on the PCL is likely to have been based on cost of funding considerations. PCL funds are priced well below market: Macedonia will pay the IMF's variable basic rate of charge (1.31% in October 2011) plus a flat charge. In March 2011, Croatia (Foreign-Currency IDR: 'BBB−') issued a 10-year Eurobond with a yield of 6.375%. Macedonia would likely have had to pay a premium over this.

The use of the PCL speaks to fiscal and external financing vulnerabilities. This will be a source of concern while the euro area debt crisis is not resolved but Fitch does not deem it sufficient to warrant a negative rating action. Policy and economic fundamentals support the existing IDR and Outlook, and some of the uncertainties that led to the use of the PCL funds have now abated (see below).

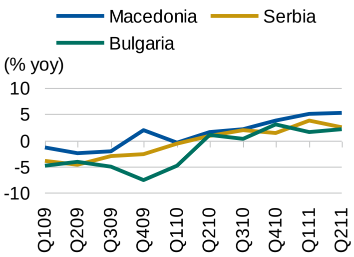
Economic Performance is Strong, but Vulnerable to Global Slowdown

Strong export growth underpinned a robust macroeconomic performance in H111. Annual real GDP growth averaged 5.2%, surpassing most expectations. Household consumption grew by 6.2% in H111 and by 8.4% in the second quarter alone, despite a contraction of 2.4% yoy in real net wages in January-July. This underlines the importance of private transfer flows in driving domestic consumption. Economic growth was also boosted by a surge in gross capital formation, which expanded by an average of 26% yoy in H111 on account of both private and public investment.

Figure 3

Robust Recovery in H111

Real GDP growth



Source: National Statistical Offices

In the remainder of the year and in 2012, Macedonia's economy is bound to suffer from the slowdown in the euro area. In September 2011 Fitch revised downward its forecasts for 2011 and 2012 GDP growth in the euro area to 1.6% from 1.7% previously and 0.8% from 1.8%, respectively. Macedonia's economy is open (exports and imports of goods total nearly 100% of GDP), and about 55% of its exports go to the EU. Greece accounted for 8% of total exports in 2010, suggesting that downside risks to the Macedonian economy from a protracted Greek recession are moderate.

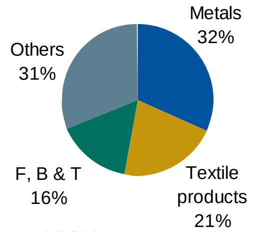
The agency forecasts that real GDP will grow by 3.8% in 2011, following growth of 1.8% in 2010. In 2012 GDP growth is projected to slow to 3.5%, as capital investment and robust household consumption will not be sufficient to offset slower growth in key trading partners. In 2013, Fitch forecasts that GDP growth will rise to 4%, as economic activity picks up in the EU, and new domestic productive capacity is put to greater use.

The Macedonian government has promoted the country as an attractive destination for investment for several years. As a result, Macedonia now ranks 38th in the World Bank's Doing Business rankings, above many of its peers and several more advanced economies. However, interest from foreign investors has picked up only recently.

Figure 4

Goods Export Structure

% of total, 2010



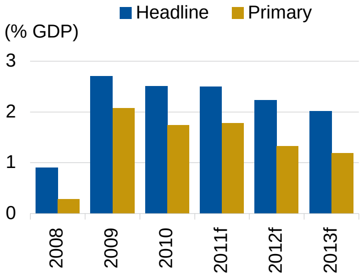
Source: NBRM

In October 2011, Johnson Controls, a US manufacturer of automotive parts already present in the country, began a second investment in the Stip technological and industrial zone (TIZ) in eastern Macedonia. Further investments are planned in the automotive, technological and pharmaceutical sectors. According to the authorities, output from Bunardzik and other TIZs could account for 16% of total exports in 2011, and possibly more in coming years as more foreign investment gets underway.

Fitch deems that these investments have the potential to diversify and upgrade the structure of the Macedonian economy (in 2010 metals and textiles still comprised over half of total exports). It could also reduce the country's chronically large trade deficit, which averaged over 20% of GDP in 2006-2010.

Figure 5

General Government Deficit

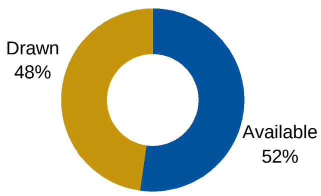


Source: Ministry of Finance, Fitch

Figure 6

Use of PCL Funds

(To end-2012, as of 18 Oct 11)



Source: IMF, Fitch

However, there are structural impediments to Macedonia achieving a potential annual growth rate of 4%-4.5%, which would allow for faster real convergence with higher-income EU countries. The official unemployment rate, at a forecast 30.7% in 2011, is far higher than both the 'BB' and 'BBB' medians. Most estimates put the 'real' rate at 20%-25%, which is still high. The discrepancy is in part due to incentives to register as unemployed to receive health insurance. The government has now severed this link, which should bring the official rate in line with the actual rate. Until effective policies are enacted to tackle this and other structural hurdles, the agency is unlikely to consider macroeconomic performance a rating strength.

Public Finances Are Still a Strength Overall

Fitch considers public finances to be a rating strength, particularly in comparison with most other countries in Europe that are struggling to rein in deficits and debt. In 2010 the central government deficit was 2.5% of GDP, in line with the official target and Fitch's expectations. In 2011, the agency expects the government to meet, or exceed only slightly, its target of keeping the deficit to 2.5% of GDP. If realised, this would yield a 10-year average deficit of 1.5% of GDP, which is below the median of both 'BB' and 'BBB-'rated countries. Despite a rise in budget deficits since 2009, public debt has remained low as a percentage of GDP, and is forecast to be 26% in 2011, well below peer countries.

Given the government's strong track record, Fitch expects it to meet its targets of reducing the deficit to about 2% of GDP by 2013 and of keeping public debt under 30% of GDP. In 2012, the government plans to reduce the budget deficit to 2.2% of GDP, in part by extending a salary and hiring freeze (a one-off increase in public wages is planned for end-2012). On the revenue side, the government is counting on higher GDP growth (4.5%) to raise the tax take. This represents the main downside risk to budget execution, as GDP growth may turn out lower than projected by the government. The government intends to bring down the budget deficit to 1.5% of GDP in the medium term, which according to IMF calculations would allow the public debt/GDP ratio to stabilise at about 25%.

The use of PCL funds denotes lingering financing vulnerabilities, and illustrates the government's limited domestic financing options. On disbursing the PCL funds to Macedonia, the IMF added a structural benchmark on the development of a functioning and liquid domestic debt market. The government has committed itself to reaching this target, and in September it issued MDK860m (EUR14m) in 5-year domestic bonds.

However, the government intends to finance itself (on a net basis) externally in 2011-13, and to repay net domestic debt. Consequently, Fitch forecasts that the stock of domestic debt will be 4.8% of GDP in 2013, down from 7.9% in 2010. According to the government's long-term debt repayment profile, gross repayments of domestic bonds issued in past years to deal with economic transition should fall sharply from the mid-2010s. Provided that the government remains committed to fostering a liquid local domestic bond market, net issuance could turn positive in the medium term, thus increasing the sovereign's financing flexibility.

A Eurobond issue is planned for the second half of 2012, possibly worth about EUR300m, with the exact timing to be determined by market conditions. Should market conditions be strained and prevent Macedonia from financing itself at favourable rates, then Fitch cannot rule out that Macedonia will draw further on PCL funds. It has SDR213m left to draw on to the end of 2012, which would in theory more than cover the planned 2012 budget deficit.

Figure 7

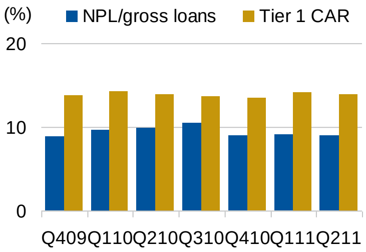
Public Finances: Sources and Uses (% GDP)

	2010	2011f	2012f	2013f
Uses	7.9	9.1	7.3	8.3
Budget balance	2.5	2.5	2.2	2.0
Amortisation (by place of issue)	5.4	6.6	5.1	6.3
Domestic	4.9	5.9	4.4	3.8
Foreign	0.5	0.7	0.7	2.5
Sources	7.9	9.1	7.3	8.3
Gross borrowing (by place of issue)	7.4	10.1	9.0	6.8
Domestic	5.6	4.9	4.2	3.5
Foreign	1.7	5.2	4.8	3.3
Privatisation	0.0	0.0	0.0	0.0
Other	0.5	-1.1	-1.7	1.5

Source: Fitch Ratings

Figure 8

Banking System is Sound



Source: NBRM

Banking Sector Is Sound and Well-Managed

The banking system has retained a low risk profile, particularly in comparison with regional peers. The funding structure of banks is balanced, with a loan/deposit ratio of 89% at the end of Q211. At that time, the banking sector's net open FX position was 10% of own funds, down from 18.9% at the end of 2010. The financial system is still shallow, with domestic credit equivalent to 46% of GDP in 2010-2011.

Banks lend prudently, with credit to the private sector growing by about 8% yoy in August, below the unsustainably high pre-crisis rates. Non-performing loans (NPL) represented 8.9% of total gross loans in June 2011, and were more than covered by total provisions (104.5%). The NPL ratio peaked in Q310 at 10.4% and has fallen since.

The banking system is almost entirely foreign-owned as local subsidiaries of foreign parent banks controlled 93% of assets at end-2010. In ordinary times, this would be a factor of strength, as a high degree of foreign ownership provides an additional backstop other than the sovereign if system solvency is threatened. However, about one-quarter of the banking system is owned by Greek parent banks. As the sovereign's debt crisis has escalated, the risk profile of several Greek banks including that of National Bank of Greece, which owns Stopanska Banka, one of the systemically important Macedonian banks has deteriorated markedly.

Fitch views exposure to Greece as only moderate additional risk to the local banking system. The subsidiaries of foreign banks in Macedonia rely little on their parents for funding and their liquidity management is run independently, which narrows this potential channel of contagion. Second, these subsidiaries are well-capitalised, which reduces the contingent call on their parents for recapitalisation. In Q211 the system Tier 1 capital adequacy ratio (CAR) was 14%. The regulatory CAR was 16.5%, double the legal minimum.

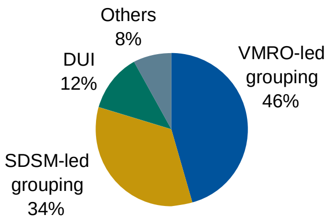
There is heightened concern about a solvency crisis in Greece. If there were one, the Macedonian authorities may need to act to prevent a loss of confidence in Greek bank subsidiaries, drawing on the PCL or other international support. The creation earlier in 2011 of a Financial Stability Council, comprised of the finance minister and the NBRM governor among others, to deal with banking crises is a step in the right direction. However, this mechanism is untested and therefore its effectiveness in a crisis is unknown.

Political Uncertainties Are Set to Remain

Political risks remain a material constraint on the rating. Progress towards EU and NATO accession is still blocked by the dispute with Greece over Macedonia's constitutional name. Given the intransigence of both sides, Fitch deems it unlikely that a mutually acceptable settlement will be found in the near term. The "name issue" will therefore block Macedonia's path towards joining western institutions. This is despite the European Commission (EC) confirming for the third consecutive year on 12 October 2011 that Macedonia is ready to begin accession negotiations.

Figure 9

Seats After 2011 Election



Source: State Election commission of Macedonia

The EU accession process is hampered by other, more deep-seated issues. In its October Progress Report, the EC acknowledged the government's commitment to aligning Macedonian legislation to EU best practices, as well as progress in several areas. However, it also highlighted 'major shortcomings in implementing and effectively enforcing legislation'. Areas where shortcomings are most acute include the judiciary, public administration reform and freedom of expression in the media. Enlargement fatigue persists among EU member states, which will also slow Macedonia's progress towards membership.

Relations between the ethnic Macedonian majority and the ethnic Albanian minority have improved steadily in recent years. The early general election held in June 2010, the run-up to which had been marred by political clashes, returned to power the outgoing coalition between the centre-right Internal Macedonian Revolutionary Organisation (VMRO) and its ethnic Albanian partner, the Democratic Union for Integration (DUI).

While Fitch does not anticipate a resumption of inter-communal conflict, tensions between ethnic constituencies have risen. A key population census was suspended in October 2011 over disagreements on how to count the ethnic Albanian population. Further delays in the EU accession process could undermine inter-ethnic relations, as the Albanian minority does not share the intransigent stance on the "name issue".

Forecast Summary

	2007	2008	2009	2010	2011f	2012f	2013f
Macroeconomic indicators and policy							
Real GDP growth (%)	6.2	5.0	-0.9	1.8	3.8	3.5	4.0
Unemployment (%)	34.9	33.8	32.2	32.1	30.7	29.8	29.0
Consumer prices (annual average % change)	2.3	8.3	-0.8	1.7	4.2	3.3	3.0
Short-term interest rate (%)[a]	5.1	6.5	8.5	7.1	5.5	5.0	5.0
General government balance (% of GDP)	0.6	-0.9	-2.7	-2.5	-2.5	-2.2	-2.0
General government debt (% of GDP)	23.9	20.4	23.9	24.6	26.1	27.8	26.2
MKD per USD (annual average)	44.7	41.9	44.1	46.5	43.6	43.4	43.4
Real effective exchange rate (2000=100)	101.5	104.7	104.4	101.9	101.9	101.9	101.9
External finance							
Current account balance (USDbn)	-0.6	-1.2	-0.6	-0.3	-0.5	-0.7	-0.7
Current account balance (% of GDP)	-7.4	-12.6	-6.5	-2.9	-4.9	-6.1	-5.5
Current account balance plus net FDI (% of GDP)	1.2	-6.5	-4.5	0.4	-1.7	-2.2	-1.7
Net external debt (USDbn)	0.1	1.1	2.0	2.2	2.5	3.0	3.5
Net external debt (% of GDP)	1.4	11.1	21.1	23.9	23.9	25.9	27.4
Net external debt (% of CXR)	2.0	16.1	36.3	34.8	36.0	37.8	39.6
Official international reserves including gold (USDbn)	2.3	2.1	2.3	2.3	2.9	3.4	3.4
Official international reserves (months of CXP cover)	4.2	3.2	4.6	4.2	4.6	4.7	4.3
External interest service (% of CXR)	2.1	1.9	2.2	2.3	2.3	2.3	2.5
Gross external financing requirement (% int. reserves)	53.8	64.3	40.0	31.0	38.0	40.8	39.0
Memo: Global forecast summary							
Real GDP growth (%)							
US	1.9	-0.3	-3.5	3.0	1.5	1.8	2.6
Japan	2.3	-1.2	-6.3	4.0	-0.3	2.5	1.3
Euro area	3.0	0.4	-4.2	1.7	1.6	0.8	1.5
World	4.2	1.6	-2.5	3.9	2.6	2.7	3.1
Commodities							
Oil (USD/barrel)	72.7	97.7	61.9	79.6	110.0	100.0	100.0

[a] Central bank bill rate (annual average)
Source: Fitch

Comparative Analysis: Macroeconomic Performance and Policies

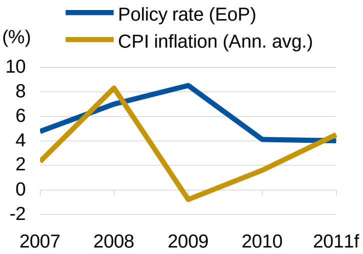
Macedonia

	2010						
	Guatemala 'BB+'	Iceland 'BB+'	Indonesia 'BB+'	Macedonia 'BB+'	Turkey 'BB+'	'BB' median	'BBB' median
Real GDP (5yr average % change)	3.7	0.2	5.7	3.4	3.3	4.4	3.6
Volatility of GDP (10yr rolling SD)	1.6	4.8	0.9	3.3	5.5	2.8	3.4
Consumer prices (5yr average)	6.3	7.7	7.7	2.9	8.7	7.7	4.7
Volatility of CPI (10yr rolling SD)	2.9	4.0	3.1	2.6	17.5	3.1	2.2
Years since double-digit inflation	2.0	1.0	4.0	15.0	2.0	n.a.	n.a.
Unemployment rate	-	8.1	7.1	32.1	11.9	8.1	9.0
Type of exchange rate regime	Managed float	Free float	Managed float	Peg	Free float	n.a.	n.a.
Dollarisation ratio	24.5	-	14.5	55.5	27.6	38.2	35.0
REER volatility (10yr rolling SD)	3.4	12.0	9.9	2.8	9.1	7.8	5.3

Source: Fitch

Figure 10

Prudent Monetary Policy

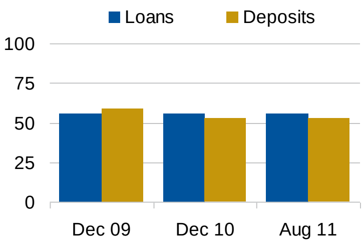


Source: Ministry of Finance

Figure 11

Euroisation Still High

(% FX-denominated or linked)



Source: NBRM, Fitch

Strengths

- The macroeconomic environment is stable, with volatility of GDP growth and inflation in line with the 'BB' and 'BBB' medians. This is owed to the authorities' success in keeping fiscal deficits low and to the denar's informal peg to the euro.
- Commitment to the peg has fostered remarkable stability in Macedonia's real effective exchange rate (REER), the medium-term volatility of which is well below the median of 'BB' and 'BBB'-rated countries.
- The adoption of the policies necessary to support the peg (FX reserve accumulation and high interest rates) has kept Macedonia's average inflation in recent years considerably lower than that of its peer group.

Weaknesses

- GDP growth was above potential in H111. Stronger GDP outcomes are held back by structural bottlenecks such as high unemployment. Macedonia would need to raise its trend GDP growth to around 4.5%-5% from the current 3%-3.5% to converge faster with western European economies.
- The unemployment rate is exceptionally high relative to Macedonia's rating peers, and underlines the persistence of macroeconomic imbalances. The abolition of the obligation to register as unemployed to obtain free health insurance could reduce distortions in the labour market, but more active policies will be needed to mitigate sharp supply-demand mismatches.
- Although it is coming down gradually, the use of euros in banking sector deposits and loans is high, and well above the median for 'BB'-rated countries. This reduces the flexibility of monetary policy to counter macroeconomic shocks, while increasing the vulnerability to crises of confidence in the banking sector.

Commentary

After averaging 1.7% in 2010, headline consumer-price (CPI) inflation rose to 4.1% yoy in the first nine months of 2011. The rise was driven by food and energy prices, with underlying inflation (excluding food, tobacco, fuel and heating) at about 1%. Against a backdrop of strong economic growth and rising headline inflation, the NBRM has maintained its policy interest rate steady at 4% throughout 2011.

The primary aim of monetary policy throughout 2011-2013 will be to keep FX reserves at adequate levels, to support the denar's peg to the euro. Therefore NBRM policy is likely to be largely dictated by the European Central Bank's (ECB) stance. Fitch now expects the key ECB policy rate to be left unchanged until 2013.

Comparative Analysis: Structural Features

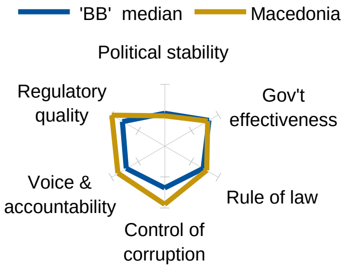
Macedonia

	2010						
	Guatemala 'BB+'	Iceland 'BB+'	Indonesia 'BB+'	Macedonia 'BB+'	Turkey 'BB+'	'BB' median	'BBB' median
GNI per capita PPP (USD, latest)	4,570	28,630	4,300	10,830	14,580	5,910	12,695
GDP per capita (USD, mkt exchange rates)	2,864	38,219	3,039	4,463	9,713	3,506	9,329
Human Development Index (percentile, latest)	31.5	90.4	36.3	57.7	51.1	46.4	64.5
Ease of Doing Business (percentile, latest)	45.1	92.4	34.1	79.7	64.9	44.6	74.0
Trade openness (CXR and CXP % GDP)	39.6	58.5	25.7	70.2	25.2	45.0	46.6
Gross domestic savings (% GDP)	5.6	23.1	34.2	6.0	14.6	15.7	23.0
Gross national savings (% GNP)	14.8	3.4	34.3	22.5	13.8	17.7	23.3
Gross domestic investment (% GDP)	16.5	12.6	32.5	24.8	20.1	20.6	24.0
Private credit (% GDP)	23.4	107.6	26.0	45.6	43.9	31.0	68.3
BSR Indicators	n.a.	n.a.	D	n.a.	C	n.a.	n.a.
Bank system CAR	15.1	17.8	16.3	16.1	19.0	16.3	15.0
Foreign bank ownership (% assets)	10.3	-	43.0	92.9	16.0	44.9	44.9
Public bank ownership (% assets)	1.7	-	46.0	2.3	32.0	25.6	14.9
Default record (year cured)[a]	1989	-	2002	1997	1982	n.a.	n.a.

[a] Modern Sovereign Debt 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.
Source: Fitch and World Bank

Figure 12

Governance Indicators
2010



Source: World Bank

Strengths

- Macedonia's GDP per capita is slightly higher than the 'BB' median when measured at market exchange rates. The gap is wider in terms of GNI per capita measured at purchasing power parity (PPP).
- Macedonia's economy is open, but largely undiversified, with the metals and textile industries providing about 42% of total export receipts in 2010. However, a number of large foreign investments into the automotive, electronics and pharmaceutical sectors will diversify the economy and possibly put it on a higher growth trajectory.
- The June 2011 general election was judged to have been reasonably free and fair by international organisations. This was in contrast to the previous election, in 2008, which had been marred by irregularities.
- Commitment to reform of the business environment in recent years earned Macedonia a steady rise in the World Bank's Doing Business survey, where the country is now ranked 22nd.

Weaknesses

- There remains a far larger gap between gross domestic and gross national savings than in other 'BB'-rated countries, which is explained by the large amount of 'private transfer' flows. These are partly workers' remittances, which could become volatile as economies that host Macedonian workers enter a downturn.
- The current government has staked much of its political capital on obtaining a clear timetable for EU accession. However, its nationalist leanings have also riled Greece, meaning that a solution to the 'name issue' could suffer further delay. This would delay the EU accession process indefinitely.
- The largest ethnic-Albanian party plays a more important role than under the previous government, which should help to stabilise inter-ethnic relations. However, mutual mistrust persists, as evidenced by the scrapping of a key population census in October 2011, and could increase the longer the 'name issue' drags on.

Comparative Analysis: External Finances

Macedonia

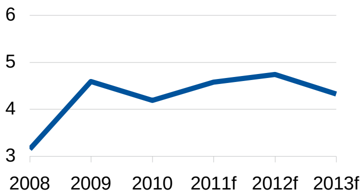
	2010					Last 10 years	
	Guatemala 'BB+'	Iceland 'BB+'	Indonesia 'BB+'	Macedonia 'BB+'	Turkey 'BB+'	'BB' median	'BBB' median
GXD (% CXR)	44.9	1,746.6	103.8	92.6	189.1	101.2	95.8
GXD (% GDP)	17.3	935.5	27.1	63.6	41.6	38.8	48.4
NXD (% CXR)	34.6	1,413.9	37.0	34.8	88.7	15.3	17.9
NXD (% GDP)	13.3	757.3	9.6	23.9	19.5	7.2	7.9
GSXD (% GXD)	81.8	5.4	63.6	28.7	36.6	52.8	33.3
NSXD (% CXR)	38.4	8.8	13.8	-5.5	16.1	7.7	-9.9
NSXD (% GDP)	14.8	4.7	3.6	-3.8	3.5	2.9	-6.0
SNFA (USDbn)	-6.1	-0.6	-10.0	0.3	-26.0	-1.0	5.3
SNFA (% GDP)	-14.8	-4.5	-1.4	3.8	-3.5	-3.2	7.2
Ext. debt service ratio (% CXR)	5.9	72.8	18.9	9.5	37.9	14.4	14.3
Ext. interest service ratio (% CXR)	3.1	26.7	7.0	2.3	5.3	4.1	3.9
Liquidity ratio (latest)	325.4	8.6	126.0	144.1	92.0	153.1	137.0
Current account balance (% GDP)	-2.1	-9.8	0.8	-2.9	-6.5	-2.0	-2.4
CAB plus net FDI (% GDP)	-0.5	29.5	2.3	0.4	-5.4	1.6	0.7
Commodity dependence (% CXR, latest)	29.9	42.2	49.8	24.4	14.4	28.9	20.6
Sovereign net FX debt (% GDP)	-0.3	-3.3	-0.4	-5.2	2.7	2.5	-4.2

Source: Fitch

Figure 13

Adequate Official Reserves

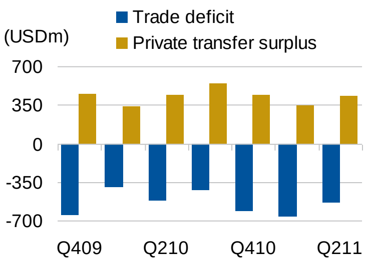
FX reserves (in months of CXP cover)



Source: IFS, Fitch

Figure 14

Trade Imbalance



Source: NBRM, Fitch

Strengths

- Despite a slight fall, Macedonia's international liquidity ratio remains in line with the medians of the 'BB' and 'BBB' categories.
- The sovereign is a net external creditor, reflecting low government debt and the NBRM's foreign exchange reserves.
- Macedonia's external debt service ratio is below the 'BB' and 'BBB' medians. At the end of Q211 trade credits and intercompany lending made up 37% of total external debt. This contributes to a lower interest service ratio than the peer-group median.
- Domestic banks are not reliant on foreign financing and are not significantly indebted abroad on a net basis. This compares favourably with many banking systems in the region.

Weaknesses

- Macedonia runs large trade deficits, upwards of 20% of GDP, as a result of its undiversified production base. Private transfers (comprised of workers' remittances and residents' transactions at cash-exchange houses), at about 17% of GDP, offset the trade deficit to a large degree.
- The government's PCL drawdown will contribute to reducing the SNFA to 0.7% of forecast 2011 GDP (1.1% of CXR) from a pre-crisis (2007) peak of 11.4% of GDP (15.8% of CXR). While higher than the 10-year median for 'BB'-rated countries, the 2011 estimates are below those for 'BBB'-rated countries.
- The government intends to launch a new Eurobond in the second half of 2012, and has committed to do so even if it has to pay unfavourable interest rates. However, markets may still be in turmoil, forcing Macedonia to draw down further its PCL. This would deepen the country's dependence on multilateral financing and delay its transition to market-based financing.

Commentary

Fitch forecasts that the CAD will rise to 4.9% of GDP in 2011 from 2.9% in 2010. The agency expects the CAD to rise further in 2012, as global energy prices remain high and new FDI projects cause an increase in imports. In 2013 the CAD/GDP ratio is forecast to edge lower, as new productive capacity boosts exports.

Comparative Analysis: Public Finances

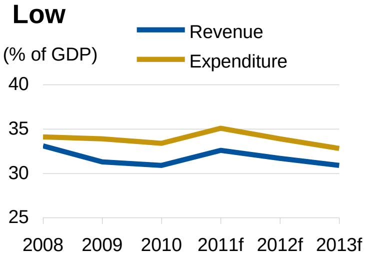
Macedonia

	2010					Last 10 years	
	Guatemala 'BB+'	Iceland 'BB+'	Indonesia 'BB+'	Macedonia 'BB+'	Turkey 'BB+'	'BB' median	'BBB' median
Budget balance (% GDP)	-3.3	-5.4	-0.6	-2.5	-3.3	-2.3	-2.5
Primary balance (% GDP)	-1.8	-2.5	0.8	-1.7	0.1	0.2	-0.2
Revenue and grants (% GDP)	11.3	42.3	15.8	31.2	35.0	25.1	32.9
Volatility of revenue/GDP ratio	6.3	5.9	8.5	5.7	4.6	6.2	6.8
Interest payments (% revenue)	13.2	12.1	8.7	2.4	12.8	11.3	7.3
Debt (% revenue)	217.4	218.4	162.8	79.1	118.7	163.3	117.8
Debt (% GDP)	24.5	92.4	25.7	24.6	41.6	40.1	35.8
Net debt (% GDP)	18.0	67.1	23.4	24.6	37.9	34.7	29.9
FC debt (% total debt)	57.7	46.3	51.5	74.2	34.7	64.7	32.4
CG debt maturities (% GDP)	0.6	13.8	1.9	5.4	13.5	4.8	5.8
Average duration of CG debt (years)	-	0.0	5.7	1.2	2.3	3.4	4.5

Source: Fitch

Figure 15

Government Ratios are Low



Source: Ministry of Finance

Strengths

- Fiscal deficits remained modest even during the 2008-09 economic downturn, suggesting that discipline is entrenched, which is important given the denar's euro peg. Fitch forecasts incremental reductions in the budget deficit to about 2% of GDP in 2013.
- A long track record of low budget deficits has constrained the growth of public debt. Public debt is only 25% of GDP and 80% of revenue, far below the respective medians of the 'BB' and 'BBB' categories. Fitch expects public debt to remain below 30% of GDP in the medium term.
- The risk to the sovereign of contingent liabilities arising from the banking or corporate sectors is low.

Weaknesses

- The government's decision to make use of part of the IMF PCL suggests that Macedonia's fiscal policy framework is still suffers from weaknesses. The main one is a lack of financing flexibility on domestic issuance, which is mostly foreign currency-indexed and short-term (there is a prevalence of six-month treasury bills).
- The prevalence of short-term debt in domestic issuance means that the average duration of central government debt is low compared with the 'BB' median.

Commentary

The ratio of interest payments to GDP and revenue is currently low. It will rise progressively as the sovereign 'graduates' from concessional to market-based financing. Although this will take time to feed through into debt service, the government could come under increased pressure to achieve smaller primary deficits, and eventually surpluses, if it is to achieve its medium-term aim of reducing the budget deficit to 1.5% of GDP.

Under the IMF's guidance, the government has resumed efforts to develop a domestic yield curve, and in September it issued a (small) amount of domestic bonds that were primarily aimed at second-pillar pension funds. There is further scope for developing this channel of financing, but the sovereign intends to finance itself primarily on foreign markets in 2012-13.

Figure 16

Fiscal Accounts Summary

(% GDP)	2008	2009	2010	2011f	2012f	2013f
Central government						
Revenue	**33.1**	**31.4**	**31.2**	**32.0**	**31.5**	**29.8**
Expenditure and net lending	**34.1**	**34.1**	**33.7**	**34.5**	**33.7**	**31.8**
O/w current expenditure and transfers	30.0	32.8	33.0	31.3	29.8	-
- interest	0.6	0.6	0.8	0.8	0.9	-
O/w capital expenditure	6.5	6.8	7.7	7.7	7.1	-
Current balance	3.2	-1.4	-1.9	0.7	1.7	-
Primary balance	-0.3	-2.1	-1.7	-1.7	-1.3	-
Overall balance	**-0.9**	**-2.7**	**-2.5**	**-2.5**	**-2.2**	**-2.0**
Central government debt	20.4	23.9	24.6	26.1	27.8	26.2
% of central government revenues	61.6	76.1	79.1	81.5	88.5	88.0
Central government deposits	**2.3**	**1.0**	**0.1**	**1.1**	**2.7**	**1.0**
Net central government debt	18.1	22.9	24.6	25.0	25.1	25.3
Central government debt (MKDbn)	84.0	97.8	104.5	121.0	140.7	143.5
By place of issue						
Domestic	28.2	30.1	32.8	28.3	27.2	25.8
Foreign	55.8	67.6	71.7	92.7	113.5	117.7
By currency denomination						
Local currency	8.5	3.2	27.9	34.7	41.4	-
Foreign currency	76.6	94.5	83.7	95.1	106.6	110.7
In USD equivalent (eop exchange rate)	1.8	2.2	1.8	2.2	2.5	2.6
By maturity						
Less than 12 months (residual maturity)	-	-	-	-	-	-
Average maturity (years)	6.5	5.5	5.1	5.0	4.9	-
Average duration (years)	1.9	1.3	1.2	1.2	1.0	-
Memo						
Nominal GDP (MKDbn)	411.7	409.1	423.9	463.7	505.4	546.6

Source: Ministry of Finance and Fitch estimates and forecasts

Figure 17

External Debt and Assets

(USDbn)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Gross external debt	**1.7**	**1.6**	**2.3**	**2.8**	**2.9**	**3.2**	**4.0**	**4.5**	**5.5**	**5.8**
% of GDP	48.1	43.3	48.6	50.1	48.0	48.2	49.1	45.6	59.3	63.6
% of CXR	90.6	84.2	89.6	91.0	76.7	71.4	67.9	66.0	102.1	92.6
By maturity										
Medium- and long-term	1.4	1.6	1.9	2.2	2.3	2.4	2.7	3.2	4.0	4.2
Short -term	0.3	0.1	0.5	0.6	0.6	0.7	1.3	1.3	1.5	1.6
% of total debt	18.1	5.4	19.9	20.5	21.7	23.3	33.6	28.9	27.1	27.5
By debtor										
Monetary authorities	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.0**	**0.0**	**0.1**	**0.1**
Central government	**1.4**	**1.2**	**1.4**	**1.4**	**1.6**	**1.5**	**1.3**	**1.3**	**1.6**	**1.7**
Banks	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.3**	**0.6**	**0.5**	**0.7**	**0.8**
Other sectors	**0.1**	**0.3**	**0.8**	**1.2**	**1.1**	**1.4**	**2.1**	**2.7**	**3.2**	**3.3**
Gross external assets (non-equity)	**1.7**	**1.3**	**1.8**	**2.1**	**2.4**	**3.2**	**3.9**	**3.4**	**3.5**	**3.6**
International reserves, incl. gold	0.8	0.8	0.9	1.0	1.3	1.9	2.3	2.1	2.3	2.3
Other sovereign assets nes	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit money banks' foreign assets	0.6	0.6	0.7	0.8	0.7	0.9	0.9	0.5	0.7	0.8
Other sector foreign assets	0.0	0.0	0.2	0.3	0.3	0.5	0.7	0.7	0.9	0.9
Net external debt	**0.0**	**0.3**	**0.5**	**0.6**	**0.5**	**-0.1**	**0.1**	**1.1**	**2.0**	**2.2**
% of GDP	-0.5	8.0	10.1	11.8	7.8	-0.8	1.4	11.1	21.1	23.9
% of CXR	-0.9	15.6	18.7	21.3	12.4	-1.2	2.0	16.1	36.3	34.8
Net sovereign external debt	0.3	0.4	0.4	0.5	0.2	-0.4	-0.9	-0.8	-0.3	-0.3
% of GDP	10.0	11.0	8.8	8.2	3.9	-6.5	-11.4	-8.3	-3.7	-3.8
Net bank external debt	-0.5	-0.4	-0.5	-0.7	-0.5	-0.5	-0.4	0.0	0.0	0.1
Net other external debt	0.1	0.3	0.6	0.9	0.8	0.9	1.4	1.9	2.3	2.4
Net international investment position	**-**	**-**	**-2.0**	**-2.5**	**-2.3**	**-2.5**	**-3.5**	**-4.6**	**-6.3**	**-6.7**
% of GDP	-	-	-42.0	-45.3	-39.0	-37.7	-43.2	-46.8	-67.7	-73.9
Sovereign net foreign assets	**-0.3**	**-0.4**	**-0.4**	**-0.5**	**-0.2**	**0.4**	**0.9**	**0.8**	**0.3**	**0.3**
% of GDP	-10.0	-11.0	-8.8	-8.2	-3.9	6.5	11.4	8.3	3.7	3.8
Debt service (principal & interest)	**0.2**	**0.2**	**0.3**	**0.3**	**0.2**	**0.6**	**0.5**	**0.3**	**0.4**	**0.6**
Debt service (% of CXR)	12.4	12.3	9.9	8.4	6.5	12.9	9.1	5.1	6.7	9.5
Interest (% of CXR)	4.4	2.9	2.2	1.8	1.7	2.2	2.1	1.9	2.2	2.3
Liquidity ratio (%)	214.9	267.3	392.0	225.1	224.0	173.0	215.7	188.1	159.9	144.1
Net sovereign FX debt (% of GDP)	22.4	23.9	20.4	18.9	11.8	0.7	-5.1	-3.6	-0.8	-5.2
Memo										
Nominal GDP	3.4	3.8	4.8	5.5	6.0	6.6	8.2	9.8	9.3	9.1
Gross sovereign external debt	1.6	1.3	1.5	1.5	1.7	1.6	1.3	1.3	1.7	1.8
Inter-company loans	-	-	0.1	0.3	0.2	0.3	0.5	0.8	1.2	1.2

Sources: NBP, IMF, World Bank and Fitch estimates and forecasts

Figure 18

Debt Service Schedule on Medium- and Long-Term Debt at 30 September 2011

(USDbn)	H210	2011	2012	2013	2014	2015	2016
Sovereign	**35**	**68**	**78**	**322**	**213**	**498**	**388**
Official bilateral	6	11	11	11	10	10	10
O/w Paris Club	0	0	0	0	0	0	0
Multilateral	29	57	67	75	203	286	203
O/w IMF	0	0	0	0	113	150	38
Other	0	0	0	236	0	203	176
Bonds placed in foreign markets							
Interest	40	54	65	75	79	96	90
Total sovereign debt service	**75**	**122**	**143**	**397**	**292**	**594**	**478**

Sources: Ministry of Finance

Figure 19

Balance of Payments

(USDbn)	2008	2009	2010	2011f	2012f	2013f
Current account balance	**-1.2**	**-0.6**	**-0.3**	**-0.5**	**-0.7**	**-0.7**
% of GDP	-12.6	-6.5	-2.9	-4.9	-6.1	-5.5
% of CXR	-18.2	-11.1	-4.2	-7.5	-8.9	-8.0
Trade balance	**-2.6**	**-2.2**	**-1.9**	**-2.3**	**-2.7**	**-2.7**
Exports, fob	4.0	2.7	3.3	4.0	4.5	5.2
Imports, fob	6.6	4.8	5.2	6.3	7.2	7.9
Services, net	**0.0**	**0.0**	**0.1**	**0.0**	**0.0**	**0.1**
Services, credit	1.0	0.9	0.9	0.7	1.0	1.1
Services, debit	1.0	0.8	0.8	0.8	1.0	1.0
Income, net	**-0.1**	**-0.1**	**-0.2**	**-0.1**	**-0.1**	**-0.1**
Income, credit	0.3	0.2	0.2	0.3	0.3	0.3
Income, debit	0.4	0.3	0.4	0.4	0.4	0.4
O/w: interest payments	0.1	0.1	0.1	0.2	0.2	0.2
Current transfers, net	**1.5**	**1.6**	**1.8**	**1.9**	**2.1**	**2.1**
Memo						
Non-debt-creating inflows (net)	0.3	0.0	0.2	0.3	0.3	0.3
O/w equity FDI	0.3	0.0	0.2	0.3	0.3	0.3
O/w portfolio equity	0.0	0.0	0.0	0.0	0.0	0.0
O/w other	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (- =increase)	0.0	0.1	0.1	0.5	0.6	0.0
Gross external financing requirement	1.5	0.8	0.7	0.9	1.2	1.3
Stock of international reserves, incl. gold	2.1	2.3	2.3	2.9	3.4	3.4

Sources: IMF and Fitch estimates and forecasts

The ratings above were solicited by, or on behalf of, the issuer, and therefore,
Fitch has been compensated for the provision of the ratings.