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 IDR	Stable

Financial Data

Macedonia

USDbn	2012
GDP	9.8
GDP per head (USD, thousands)	4.8
Population (m)	2.0
International reserves	2.9
Net external debt (% GDP)	18.8
Central government total debt (% GDP)	31.4
CG foreign-currency debt	2.2
CG domestically issued debt (MKDbn)	28.9

Related Research

Macedonia (November 2011)

Global Economic Outlook (September 2012)

Analysts

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Key Rating Drivers

Solid ‘BB+’ Credit: Macedonia’s IDRs balance a solid macroeconomic and banking supervision framework and an increase in productive FDI against persistent structural deficiencies and lingering fiscal vulnerabilities.

Growth to Pick Up: GDP growth turned negative in H112, and Fitch Ratings does not expect full-year GDP growth to exceed 0.5%. Increasing FDI will allow growth to pick up to 2% in 2013 and 3.5% in 2014. FDI in sectors such as automotive has the potential to reduce a large structural trade deficit and diversify Macedonia’s economy.

Higher Budget Deficits: In September 2012 the government announced that budget arrears totalled 2% of GDP, after revenue underperformance during the year. It concomitantly put forth a plan to clear these arrears, which will raise the budget deficit target (cash basis) to 3.5% in 2012 and 2013. Fitch believes these targets are within reach, in light of Macedonia’s strong fiscal track record. The agency projects public debt to rise somewhat faster than previously expected, to 33.8% of GDP in 2014, but to remain below the ‘BB’ median.

Increased Domestic Issuance: Domestic issuance of government securities, at both short- and medium-term maturities, was far larger than initially projected (about EUR285m against EUR60m). Larger and more liquid domestic treasury bill and bond markets increase the sovereign’s financing flexibility. However, reliance on commercial bank loans to meet maturing external obligations in 2012-2013 points to constrained external financing options.

Moderate Current Account Deficits: Fitch does not expect the current account deficit (CAD) to exceed 3% of GDP in 2012-2014. In line with historical experience, private transfer flows (up by 30% yoy in January-August 2012) will finance most of the large trade deficit.

Political Risk Constrains Rating: The Progress Report released by the European Commission in October 2012 praised progress in several areas, but highlighted shortcomings in others. Greece and (most recently) Bulgaria have expressed opposition to Macedonia’s EU accession bid. Prolonged stalling of Macedonia’s EU and NATO bids could spill over into domestic political instability.

What Could Trigger a Rating Action

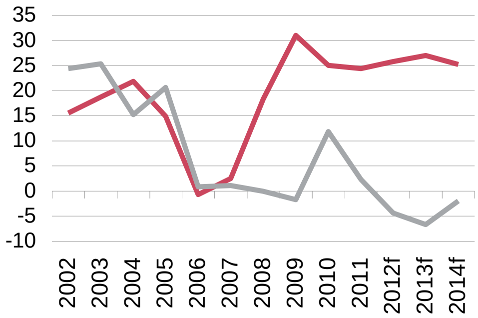
Fiscal Slippage: A material overshooting of the revised 2012-2013 budget deficit targets, along with the failure to present a plan to prevent the re-occurrence of fiscal arrears (and more generally make improvements to medium-term fiscal governance) could put downward pressure on the rating.

Further Eurozone Deterioration: Worse-than-expected growth outturns in the EU, Macedonia’s main trade partner, or spill-overs from any increased turmoil in Greece would increase downward pressure on the rating.

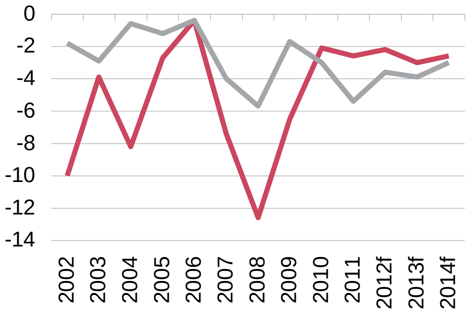
Economic Diversification: Successful diversification of Macedonia’s economic structure, eurozone stabilisation, and continued progress in meeting EU requirements could put upward pressure on the rating over the medium term.

Peer Comparison

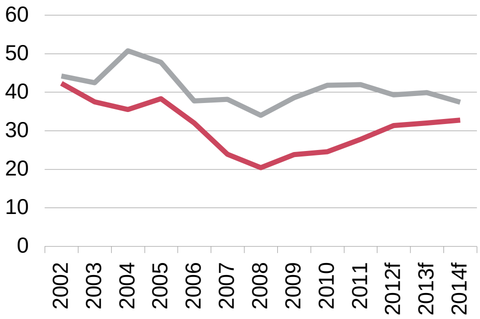
Net External Debt
% of CXR



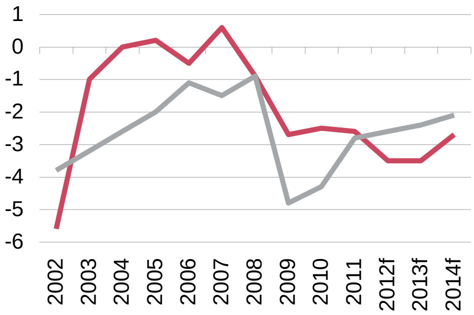
Current Account Balance
% of GDP



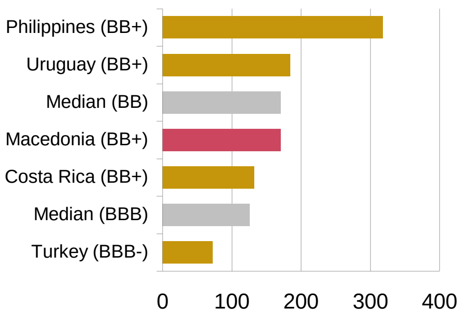
General Government Debt
% of GDP



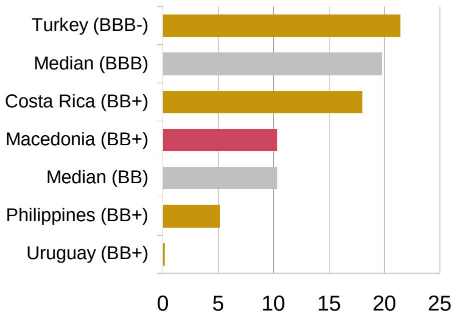
General Government Balance
% of GDP



International Liquidity Ratio, 2012
%



GDP per capita Income, 2012e
At market exchange rates, USA=100



Macedonia   Medians

Related Criteria

Sovereign Rating Methodology (August 2012)

Rating Factors

Peer Group

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

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
13 Jun 06	BB+	BB+
01 Nov 05	BB	BB

Summary: Strengths and Weaknesses

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

Note: Relative to 'BB' category (sovereigns rated 'BB+', 'BB' and 'BB−')
Source: Fitch

Strengths

- Macedonia benefits from a stable and well-managed macroeconomic policy framework.
- It has lower government debt than the 'BB' and 'BBB' ratings medians.
- The banking sector is sound and well supervised. The system capital adequacy ratio (CAR) is more than double the legal minimum (8%) and non-performing loans (NPLs) are more than fully covered by provisions.
- Recent FDI projects and a substantial pipeline in 2013-2014 could diversify the productive and export base, and raise Macedonia's potential GDP growth, which has been lagging behind that of 'BB' peers.
- Commitment to the Macedonian denar's informal peg to the euro is strong, and backed up by adequate foreign-exchange reserves (FXR).

Weaknesses

- The emergence of fiscal arrears suggests that further improvements are needed in fiscal governance.
- The domestic debt market is under-developed, despite a rise in issuance in 2012. This constrains the sovereign's financing flexibility.
- Unemployment is high at 31% officially (most estimates put the actual rate at 20%-25%).
- The trade deficit is structurally high, at over 20% of GDP a year since 2004.
- Despite continuing progress in several areas, EU accession remains a distant prospect as long as the "name issue" between Macedonia and Greece remains unresolved, and other structural shortcomings are not addressed.

Local Currency Rating

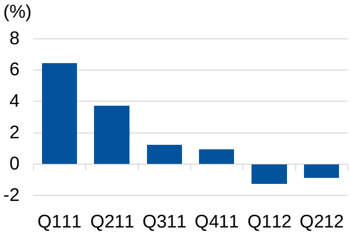
Macedonia's Local-Currency Long-Term IDR is 'BB+', the same as its Foreign-Currency Long-Term IDR. The central bank's capacity to generate local currency without negative economic consequences is restricted by the fixed exchange-rate regime. In 2012 the state increased the proportion of its funding it obtains domestically, but a deep and liquid domestic market for government securities will develop only gradually.

Country Ceiling

Macedonia's Country Ceiling of 'BBB−' reflects 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 to one notch.

Figure 1

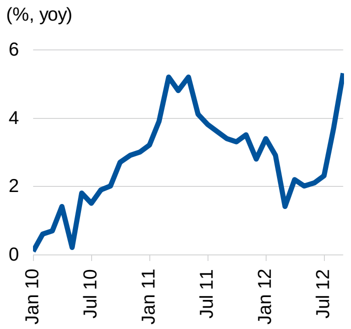
Annual Real GDP Growth



Source: SSO

Figure 2

Food Prices Affect Inflation



Source: SSO

Outlook and Key Issues

Increased FDI to Drive Growth

Fitch has revised down its estimate of 2012 growth to 0.5% after the onset of recession in Macedonia in H112 (GDP contraction of 1.1% yoy). This still implies growth of around 2% yoy in H212. Growth will benefit from a positive base effect and should be driven by domestic demand. Fixed investment in particular will be supported by FDI and other private investment, such as credit disbursements from the European Investment Bank. However, net foreign trade is likely to be a drag on growth, despite previous FDI starting to show in export figures (January-July 2012 exports in euro terms equal January-July 2011, despite the EU slowdown).

In 2013 Fitch expects real growth at 2%, at the conservative end of the range predicted by the authorities and the IMF. Growth will be driven by a gradual pickup in Macedonia's EU trading partners and by investment. Fitch forecasts GDP growth of 3.5% in 2014 as the European recovery gathers pace and production is ramped up at several FDI projects.

Activity in greenfield and brownfield FDI has picked up considerably following the government's multi-year effort to improve the business environment and make the country attractive to foreign investors. Much of the FDI is concentrated in the automotive industry, where the state expects investment to total EUR150m-200m by mid-2013. The two main projects in this sector are by Johnson Matthey (UK) and Johnson Controls (US). The government estimates that between them these two companies will export goods worth EUR500m-600m in 2012, contributing 16% of total Macedonian exports.

Johnson Matthey, which produces catalytic converters, has invested an additional EUR60m, creating 100 additional jobs (alongside 300 current jobs). This will strengthen Macedonia's position as a leading global producer and exporter of catalytic converters. This sector is less cyclical than automobile production, as sales are driven in part by efficiency and pollution standards. Furthermore, they are considered high value-added products, as they contain platinum.

Johnson Controls, which produces car seat textiles (a labour intensive industry), is building a new factory in Macedonia. This EUR20m investment will create 1,500 jobs. This project is within one of the free trade zone established by the government to promote investment. Other FDI is in the real estate, food processing and pharmaceutical and windmill industries. Turkish and Russian companies are prominent in these fields.

Despite the current activity, Fitch expects net FDI is to be only 2%-3% of GDP in 2012. An outflow of intercompany loans may be holding back FDI inflows on a net basis. However, the investments that are being made are likely to help FDI inflows reach 4%-5% of annual GDP in the medium term. This should provide coverage for the CAD.

Fitch projects inflation to be 3% yoy in 2012, with oil and food prices the main drivers. The recent drought in the US, Russia and Europe is increasing the costs of wheat and barley, which is reflected in the August and September readings. The agency forecasts inflation at 2.5%-3.5% in 2013-2014 as food prices normalise and domestic demand only recovers gradually.

Credit growth has been 7%-9% yoy during 2012, which should support consumer demand along with private transfers (up 30% yoy in January-July 2012; see the table *External Finances* below). Real wages fell by 2.4% during 2012, putting no pressure on inflation. Credit growth is likely to remain volatile in light of the economic outlook, and dependent on banks' business plans and underwriting standards. Fitch projects it to remain 8%-9% in 2013 and 2014.

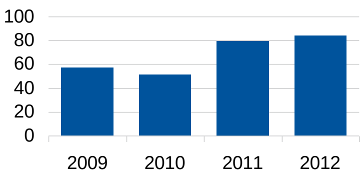
Public Finances: Sources and Uses (% GDP)

	2011	2012f	2013f	2014f
Uses	**9.2**	**9.7**	**13.5**	**11.7**
Budget balance	2.6	3.5	3.5	2.7
Amortisation (by place of issue)	6.7	6.3	9.9	8.9
Domestic	6.0	5.4	6.9	6.1
Foreign	0.7	0.8	3.1	2.8
Sources	**9.2**	**9.7**	**13.5**	**11.7**
Gross borrowing (by place of issue)	11.7	10.6	12.5	11.9
Domestic	5.6	8.5	8.0	7.3
Foreign	6.1	2.1	4.4	4.7
Privatisation	0.0	0.0	0.0	0.0
Other	-2.5	-0.9	1.0	-0.3

Source: Fitch

Figure 3

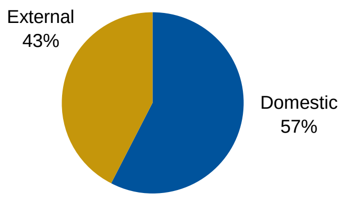
Central Budget Deficit, Jan-Aug (% of FY Target)



Source: MinFin and Fitch

Figure 4

Net Borrowing, 2007-11



Source: MinFin and FItch

Fiscal Management Shortcomings

The government admitted in September that it had accumulated budget arrears of around 2% of GDP, and announced that it would clear half by end-2012 and the other half in Q213. This will raise the general government budget deficit to 3.5% of GDP in both 2012 and 2013 from previous targets of 2.5%. Fitch considers that the revised deficit targets are within reach. However, there is a risk that they will be overshot, in light of downside risks to the external and domestic economies.

Towards end-2011 (after Fitch's most recent full rating review), it started to emerge that the government was rapidly accumulating arrears – businesses were reporting that the public administration was falling behind in VAT and other payments. The most likely cause was underperformance of revenue against unchanged budget outlays. The government has now provided a more realistic estimate of arrears, and a commitment to clear them, but has yet to devise a strategy to prevent their reoccurrence. This may be linked with criticism from the European Commission that fiscal governance standards have deteriorated.

The IMF and the government agreed that Macedonia would not make further use of Precautionary Credit Line (PCL) funds. These totalled SDR213m after the March 2011 purchase (see the 2011 Full Rating Report on Macedonia under *Related Research* for more details). The PCL will therefore be allowed to expire in early 2013. Fitch considers that an IMF agreement of a similar nature could be arranged relatively quickly, should the need arise, as Macedonia's policy fundamentals remain strong despite the frailties mentioned above.

In early November the government passed the 2013 budget, which is based on a GDP growth forecast of 2% (incorporating growth in gross investments of 6%) and average inflation of 3.5%. These forecasts are in line with Fitch's. Budget revenue is projected at MKD148bn (USD3.1bn), little changed from 2012. Expenditure, at MKD166bn, will be focused on increasing standards of living and bridging the country's considerable infrastructural gaps. With this in mind the 2013 budget provides for a 10% increase in capital expenditure, mainly in the transport, energy, utility, health care and education sectors.

In light of the ambitious scope of the government's capital spending programme, coupled with downside risks to the (admittedly conservative) revenue forecast, there is a risk that even the revised 2013 budget deficit target will be overshot. Nevertheless, the government has stated its intention to stick to the 3.5% of GDP deficit target even if revenue underperforms. Based on historical experience, the government may resort to under-execution of capital expenditure to fit inside the 3.5% envelope. One pointer in this regard is that two-thirds of the way through the 2012 budget period, capital expenditure is slightly less than 50% of the full-year target.

The government is covering fiscal financing for 2012-2013 through a variety of sources. In 2012 it has obtained a commercial loan from Deutsche Bank, a Development Policy Loan (DPL) from the World Bank, and has carried out significant domestic issuance. Fitch expects this to be sufficient to finance the budget deficit in 2012, with a substantial amount left over for 2013, including the redemption of the Eurobond due in January 2013 (EUR175m). The government plans to use a World Bank guarantee to obtain a bilateral commercial bank loan of between EUR220m and EUR250m. The redemption schedule is fairly light in 2014, but IMF and Eurobond repayments are due in 2015, which could increase pressure towards the end of the agency's forecast period.

In 2012 significant changes took place in domestic government securities issuance. Fitch expects net issuance of Macedonia denar-denominated securities to be EUR285m, against an initial full-year target of USD60m. This increase has been motivated in part by the fact that the government was unable to secure as much external financing as it was hoping to — it initially intended to borrow EUR250m from Deutsche Bank, but this was later scaled back to EUR75m.

Encouragingly, a good portion of 2012 net issuance has come with five-year (some with three years) maturity, and even T-bill issuance has shifted gradually towards 12 months from shorter maturities. According to the government, the bill/bond breakdown was 50-50. Demand has come from banks, whose liquidity position has also been eased by changes the National Bank of the Republic of Macedonia's (NBRM) brought to its operational framework in April and May 2012, and from domestic pension funds.

The latter, which started to operate in 2006, have now accumulated around EUR300m in assets, and the law governing them has been amended to prevent them from holding Macedonian Eurobonds (particularly the one maturing in 2015). This has forced them to sell Eurobonds and buy into domestic securities, driving domestic yields down and creating a captive market – the funds have steady inflows of around EUR4m a year and virtually no outflows as their members are still young.

As a result of these developments, Fitch expects the proportion of medium-term securities in the overall stock to rise to 40% at end-2012 from 25% at end-2011. The government has stated its intention of increasing issuance of securities with maturities between one and five years in 2013, and is also planning to issue securities with maturities ranging from seven to ten years. The government has preferred commercial loans that have afforded it interest savings of 2-3 percentage points over a Eurobond of similar maturity. It has plans to issue a Eurobond, but no earlier than 2014.

Monetary Policy and Banking Supervision

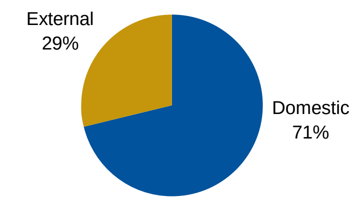
In April the NBRM lowered the interest rate on central bank bills by 25bp to 3.75% to counteract the economic slowdown. However, its focus has remained on ensuring the stability of the informal euro peg. FXRs of around EUR2.1bn (4-4.5 months of CXP) provide a buffer against economic turbulence. Falling dollarisation in the economy is not without precedent, and therefore may not necessarily indicate the start of a structural trend. Nevertheless, it points to confidence in the domestic currency and policies. A possible downside is that deposit dollarisation is falling faster than that of loans, opening up a mismatch on the banking sector's balance sheet.

The banking system CAR was 17.4% in Q212, with Tier 1 (which is close to the Basel definition of core Tier 1) at over 14%. However, capital is not equally distributed within the banking system – larger banks have the lowest CARs, whereas smaller banks have the highest. NPLs have been largely stable through the crisis, although there has been a slight upward trend in recent quarters. Smaller banks may appear on average to have higher NPLs, although this may be due to just a small number of non-performing clients. Fitch considers provisioning extremely conservative at 104% of NPLs, and it does not generally include collateral.

Greek-owned banks operating in Macedonia have CARs above the regulatory requirements, and Fitch considers them to be prudently operated. However, there is some evidence of deleveraging. According to the central bank these firms are prepared for a potential outflow of deposits in case of declining confidence in their owners, and are being closely monitored. In addition, these subsidiaries are not reliant on their parents for funding.

Figure 5

Net Borrowing, 2012

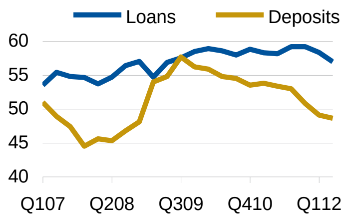


Source: MinFin and FItch

Figure 6

Euroisation Falling

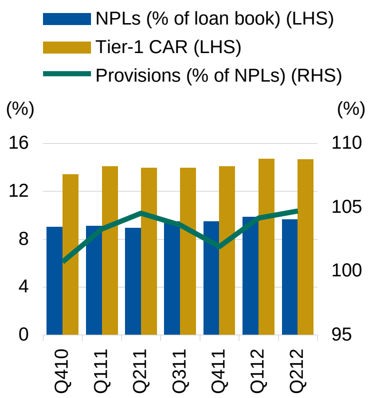
(%,FX-denominated or linked)



Source: NKBM

Figure 7

Sound Banking Sector



Source: NBRM

External Finances: Sources and Uses (USDbn)

	2011	2012f	2013f	2014f
Uses	**0.61**	**0.69**	**0.96**	**0.94**
Current account balance	0.27	0.22	0.31	0.30
MLT amortisation	0.34	0.47	0.65	0.65
Sovereign	0.07	0.08	0.32	0.32
Non-sovereign	0.27	0.39	0.33	0.33
Sources	**0.61**	**0.69**	**0.96**	**0.94**
Gross MLT borrowing	1.27	0.69	0.94	0.95
Sovereign	0.93	0.20	0.46	0.53
Non-sovereign	0.34	0.49	0.48	0.43
Net FDI	0.41	0.23	0.45	0.45
Net portfolio debt	-0.04	0.01	0.08	0.08
Net portfolio equity	-0.02	-0.03	-0.03	-0.03
Other credit flows (not elsewhere specified)	-0.55	0.03	-0.08	0.01
Net E&O	-0.01	-0.03	0.00	0.00
Change in fx reserves	-0.44	-0.20	-0.41	-0.52

Source: Fitch

External Finances

Fitch expects the CAD to be 2%-2.5% of GDP in 2012, in line with official forecasts. The agency forecasts the CAD in 2013-2014 to be roughly same level as in 2012, and the trade deficit in 2012-2013 to be little changed from 2011, at 20%-25% of GDP as increasing exports are offset by rising imports of capital and consumer goods. Private transfers (mainly conversion of mattress money, remittances and grey economy proceeds from FX into denar) are financing most of the trade deficit, as they have done historically. In January-August net private transfer inflows increased by 25% yoy in euro terms, an indication of increased confidence in the denar amid the eurozone debt crisis.

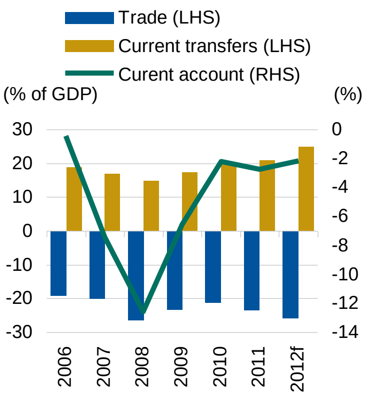
It is likely that both the large trade deficit and transfer surplus will diminish, albeit gradually, over the medium term. The NBRM assumes that private transfers as a proportion of GDP will decrease by about 1 percentage point of GDP a year in the medium term, in step with increasing denarisation (under a baseline scenario of steady economic recovery).

EU Accession and Domestic Politics

Political risk remains a material constraint on Macedonia's sovereign ratings. The European Commission confirmed on 10 October 2012, for the fourth consecutive year, that Macedonia is ready to begin accession negotiations. Progress was noted in several areas. However, the Commission also noted a number of key areas where shortcomings need to be addressed, including education and human capital, infrastructure, institutional weaknesses, and the efficiency of public administration. This underlines that a number of deep-seated issues continue to exist, beyond the "name issue".

Figure 8

Trade Imbalance Persists



Source: Datastream and Fitch

Little progress has been achieved with regard to the "name issue" between Greece and Macedonia since Fitch's most recent full rating review. A further complication is that in early November Bulgaria also withdrew its support for Macedonia's EU bid, following the re-emergence of a number of historical disputes between the two countries. This means that Macedonia's path to NATO accession and the start of EU membership negotiations is unlikely to be unblocked in the near future.

This could in turn have spillovers into domestic politics. The governing coalition between the ethnic Macedonian VMRO and the ethnic Albanian DUI survived a no-confidence motion tabled in October 2012 by the opposition Social Democrats. The relative ethnic peace was disrupted earlier in 2012 after the murder of five ethnic Macedonians. Relations between the VMRO and the DUI became strained after the former tabled a law which contemplates compensation for ethnic Macedonian veterans of the 2001 civil conflict. Fitch expects coalition relations to improve, and so ward off the threat of an early election (the current parliament ends in 2015).

Should an early election take place, opinion polls suggest that it would return the same ruling coalition to power. However, it would most likely bring policymaking to a standstill for several months before voting. Local elections are scheduled to take place in March 2013, and these will be a testing ground for the new opposition coalition (comprised of the Social Democrats and the Democratic Party of Albanians).

Forecast Summary

	2008	2009	2010	2011	2012[f]	2013[f]	2014[f]
Macroeconomic Indicators and Policy							
Real GDP growth (%)	5.0	-0.9	2.9	2.8	0.5	2.0	3.5
Unemployment (%)	33.8	32.2	32.0	31.4	30.5	29.0	28.4
Consumer prices (annual average % change)	8.3	-0.8	1.6	3.9	3.0	3.5	2.5
Short-term interest rate (%)[a]	6.5	8.5	5.7	4.0	3.5	4.0	5.0
General government balance (% of GDP)	-0.9	-2.7	-2.5	-2.6	-3.5	-3.5	-2.7
General government debt (% of GDP)	20.4	23.8	24.5	27.9	31.4	32.1	32.8
MKD per USD (annual average)	41.9	44.1	46.5	44.2	48.5	48.5	48.5
Real effective exchange rate (2000 = 100)	104.4	104.2	101.7	103.5	103.5	103.5	103.5
External finance							
Current account balance (USDbn)	-1.2	-0.6	-0.2	-0.3	-0.2	-0.3	-0.3
Current account balance (% of GDP)	-12.6	-6.5	-2.1	-2.6	-2.2	-3.0	-2.6
Current account balance plus net FDI (% of GDP)	-6.5	-4.6	0.1	1.3	0.1	1.3	1.4
Net external debt (USDbn)	1.1	1.5	1.4	1.7	1.9	2.1	2.1
Net external debt (% of GDP)	11.3	16.2	15.2	16.7	18.8	19.9	18.6
Net external debt (% of CXR)	18.3	31.0	25.0	24.4	25.8	27.0	25.2
Official international reserves including gold (USDbn)	2.1	2.3	2.3	2.7	2.9	3.3	3.8
Official international reserves (months of CXP cover)	3.5	5.0	4.7	4.3	4.7	4.9	5.3
External interest service (% of CXR)	2.2	2.1	2.2	2.5	2.5	2.4	3.3
Gross external financing requirement (% int. reserves)	64.3	40.5	31.9	26.9	22.2	33.3	21.1
Memo: Global forecast summary							
Real GDP growth (%)							
US	-0.3	-3.5	3.0	1.7	2.2	2.3	2.8
Japan	-1.0	-5.5	4.5	-0.8	2.1	1.7	1.3
Euro area	0.3	-4.2	1.8	1.5	-0.4	0.9	1.5
World	1.5	-2.3	4.0	2.7	2.1	2.6	3.0
Commodities							
Oil (USD/barrel)	97.7	61.9	79.6	111.0	110.0	100.0	100.0

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

Comparative Analysis: Macroeconomic Performance and Policies

Macedonia

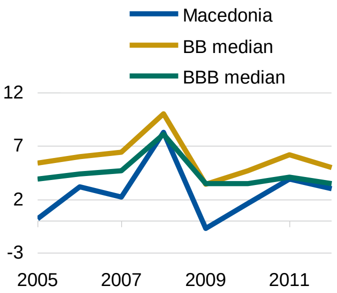
	2012						
	Turkey BBB−	Costa Rica BB+	Macedonia BB+	Philippines BB+	Uruguay BB+	BB median	BBB median
Real GDP (5yr average % change)	3.3	2.9	2.1	4.5	5.6	3.6	2.4
Volatility of GDP (10yr rolling SD)	4.5	2.8	2.2	1.8	2.5	2.2	3.4
Consumer prices (5yr average)	8.2	7.5	3.2	4.9	7.4	6.3	4.7
Volatility of CPI (10yr rolling SD)	5.5	3.3	2.5	1.8	4.0	2.7	2.4
Years since double-digit inflation	4.0	4.0	17.0	18.0	8.0	n.a.	n.a.
Unemployment rate	9.0	7.1	29.8	6.5	6.3	9.4	7.9
Type of exchange rate regime	Free float	Crawling band	Peg	Free float	Managed float	n.a.	n.a.
Dollarisation ratio	29.0	-	49.3	-	-	64.3	27.7
REER volatility (10yr rolling SD)	8.2	4.9	2.0	5.6	10.4	5.6	5.3

Source: Fitch

Figure 9

Relatively Low Inflation

(CPI, % change yoy)



Source: NKBM

Strengths

- The macroeconomic environment is stable, with volatility of GDP growth and inflation in line with the 'BB' and 'BBB' medians. This is because of the authorities' broad success in keeping fiscal deficits low and 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 for '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 considerably lower than that of its peer group in recent years.

Weaknesses

- Stronger GDP outcomes are held back by structural bottlenecks such as high unemployment. Macedonia would need to raise its trend GDP growth to 4.5%-5% from the current 3%-3.5% to converge faster with western European economies.
- The unemployment rate is exceptionally high relative to 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 and is now below the 'BB' median, dollarisation is high. This reduces the flexibility of monetary policy to counter macroeconomic shocks, while increasing vulnerability to crises of confidence in the banking sector.

Commentary

The official unemployment figure (around 32%) continues to be higher than the actual unemployment figures. These are variously estimated at 20%-25%, as a portion of the otal consists of individuals who register as unemployed to obtain health insurance benefits. Some FDI projects are labour intensive, which will help cut unemployment. However, a durable fall in unemployment will also require active labour market policies, which take several years to feed through. The official rate could go down in coming months as the government cleans up registers and implements new control systems, but this might not indicate the start of a durable downward trend.

Comparative Analysis: Structural Features

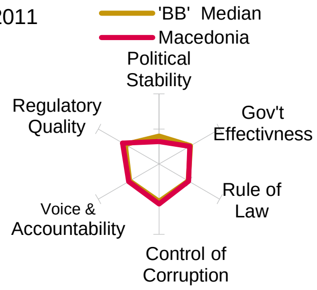
Macedonia

	2012						
	Turkey BBB−	Costa Rica BB+	Macedonia BB+	Philippines BB+	Uruguay BB+	BB median	BBB median
GNI per capita PPP (USD, latest)	16,730	11,950	11,490	4,160	14,740	6,690	13,980
GDP per capita (USD, mkt exchange rates)	10,675	8,967	4,821	2,571	15,026	4,821	9,856
Human Development Index (percentile, latest)	50.5	63.4	58.6	39.7	74.7	48.3	63.9
Ease of Doing Business (percentile, latest)	61.6	40.8	88.5	25.9	51.1	47.3	71.5
Trade openness (CXR and CXP % GDP)	29.4	33.7	73.7	33.6	29.8	52.2	48.9
Gross domestic savings (% GDP)	16.3	15.9	8.9	16.0	18.5	15.1	23.4
Gross national savings (% GNP)	14.1	17.2	26.3	24.5	18.5	16.9	24.2
Gross domestic investment (% GDP)	21.2	21.8	27.7	22.0	19.5	21.6	23.7
Private credit (% GDP)	50.7	47.0	47.1	34.7	23.7	34.7	66.1
BSR Indicators	bbb3	n.a.	n.a.	bb1	bb1	n.a.	n.a.
Bank system CAR	16.5	14.4	17.4	17.3	15.6	17.3	16.5
Foreign bank ownership (% assets)	16.3	30.1	92.8	11.9	54.1	67.5	30.7
Public bank ownership (% assets)	30.3	64.9	3.1	12.6	45.9	24.5	19.0
Default record (year cured)[a]	1982	1990	1997	1992	2003	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 10

Governance Indicators
2011



Source: World Bank

Strengths

- Macedonia's GDP per capita is higher than the 'BB' median when measured at purchasing power parity (PPP).
- Macedonia's economy is open. 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.
- Reform of the business environment in recent years earned Macedonia a steady rise in the World Bank's Ease of 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. This is because of the large amount of "private transfer" flows. These are partly workers' remittances, which have been relatively stable but could become volatile as economies that host Macedonian workers face recession.
- The current government has staked much of its political capital on obtaining a clear timetable for EU accession. However, its nationalist leanings have also angered Greece, meaning that a solution to the "name issue" could be further delayed. This would halt 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, and could increase the longer the "name issue" drags on.

Commentary

The "heightened dialogue" between EU and Macedonia, announced in March 2012, was designed to drive progress on some aspects of the accession process while the name issue with Greece is resolved. This is a positive development and could eventually entail significant progress, but may lose steam if in a few years if no material progress is achieved.

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 was marred by irregularities.

Comparative Analysis: External Finances

Macedonia

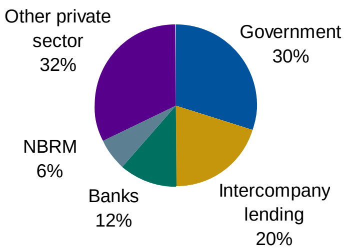
	2012					Last 10 years	
	Turkey BBB−	Costa Rica BB+	Macedonia BB+	Philippines BB+	Uruguay BB+	BB median	BBB median
GXD (% CXR)	179.1	80.0	93.3	93.5	151.5	102.1	100.7
GXD (% GDP)	46.2	24.9	67.9	32.7	44.0	41.5	49.2
NXD (% CXR)	92.0	-16.5	25.3	-48.7	-82.8	5.5	12.7
NXD (% GDP)	23.8	-5.1	18.4	-17.0	-24.1	2.3	5.4
GSXD (% GXD)	37.2	25.4	39.6	55.2	62.9	49.3	32.1
NSXD (% CXR)	12.3	-26.6	-4.3	-39.5	10.0	2.8	-10.2
NSXD (% GDP)	3.2	-8.3	-3.2	-13.8	2.9	1.6	-5.3
SNFA (USDbn)	-25.2	3.5	0.3	-	-1.4	-0.1	4.7
SNFA (% GDP)	-3.2	8.3	3.2	-	-2.9	-1.5	6.7
Ext. debt service ratio (% CXR)	30.7	16.0	9.0	10.2	13.6	13.3	14.8
Ext. interest service ratio (% CXR)	3.9	3.6	2.5	4.2	4.6	3.7	4.2
Liquidity ratio (latest)	72.9	132.5	170.8	318.2	184.9	170.4	138.3
Current account balance (% GDP)	-7.3	-5.0	-1.8	2.7	-1.5	-2.3	-2.0
CAB plus net FDI (% GDP)	-5.5	0.1	0.4	3.3	3.7	1.4	0.5
Commodity dependence (% CXR, latest)	15.5	25.6	25.8	8.2	53.6	25.5	22.5
Sovereign net FX debt (% GDP)	-1.0	-5.9	-7.3	-11.4	-1.8	0.7	-5.8

Source: Fitch

Figure 11

Banks Hold Little Foreign Debt

(% of total as of Q212)



Source: NBRM

Strengths

- Macedonia's international liquidity ratio is in line with the 'BB' median, and slightly higher than the 'BBB' median.
- The sovereign is a net external creditor, reflecting low government debt and the NBRM's foreign exchange reserves.
- Macedonia's gross external debt and interest service ratios are below the 'BB' and 'BBB' medians. 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 historically undiversified production base. Private transfers (comprised of workers' remittances and residents' transactions at cash-exchange houses) largely offset the trade deficit.
- The government has shelved plans for a Eurobond, most likely until 2014. The government is taking advantage of World Bank guarantees to borrow on more advantageous terms than via a Eurobond, but the objective of establishing a presence on international markets has been shelved for the time being.

Comparative Analysis: Public Finances

Macedonia

	2012					Last 10 years	
	Turkey BBB−	Costa Rica BB+	Macedonia BB+	Philippines BB+	Uruguay BB+	BB median	BBB median
Budget balance (% GDP)	-1.9	-4.5	-3.5	-2.6	-0.8	-2.1	-2.6
Primary balance (% GDP)	1.1	-2.1	-2.5	0.4	1.3	0.3	-0.3
Revenue and grants (% GDP)	36.7	14.7	31.0	14.3	27.6	27.2	32.4
Volatility of revenue/GDP ratio	5.9	0.9	5.6	4.8	1.1	6.2	6.0
Interest payments (% revenue)	9.6	16.4	3.1	20.6	7.6	9.2	7.1
Debt (% revenue)	101.0	225.0	101.1	277.1	164.4	163.1	120.3
Debt (% GDP)	37.0	33.0	31.3	39.5	45.4	39.9	35.5
Net debt (% GDP)	33.6	30.5	27.6	36.6	37.4	34.6	30.5
FC debt (% total debt)	35.3	19.2	85.8	51.6	47.5	64.0	39.4
CG debt maturities (% GDP)	7.3	6.7	6.3	6.7	1.3	5.0	5.4
Average duration of CG debt (years)	2.6	3.5	-	-	-	3.5	5.4

[a] GG if not otherwise specified
Source: Fitch

Strengths

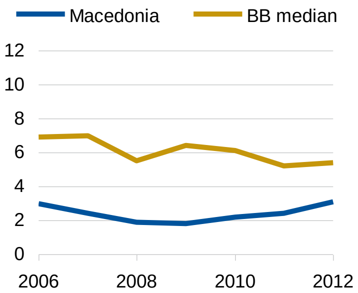
- Fiscal deficits remained modest even during the 2008-2009 economic downturn, suggesting that discipline is entrenched. This is important in light of the denar’s euro peg. Fitch forecasts a return towards a budget deficit of 2.5% of GDP in 2014 after a temporary increase to 3.5% in 2012 and 2013 in order to clear fiscal arrears.
- A long track record of low budget deficits has constrained the growth of public debt. Public debt is 33% of GDP and 100% of revenue. Although these ratios have risen in recent years, they remain far below the respective medians of the ‘BB’ and ‘BBB’ categories.
- The ratio of interest payments to general government (GG) debt is low relative to the ‘BB’ and ‘BBB’ medians, owing to the still largely concessional nature of Macedonia’s GG debt.
- The risk to the sovereign of contingent liabilities arising from the banking or corporate sectors is low.

Weaknesses

- Domestic issuance increased in 2012, in line with the IMF’s recommendations. However, the government’s decision to make use of part of the IMF PCL in 2011, and its reliance on World Bank-guaranteed bilateral commercial loans suggests that fiscal financing flexibility is still constrained.

Figure 12

Low Interest Payments
(% of GG revenue)



Source: NKBM

Figure 13

Fiscal Accounts Summary

(% of GDP)	2009	2010	2011	2012f	2013f	2014f
General government						
Revenue	**33.1**	**32.7**	**31.9**	**31.1**	**30.7**	**29.7**
Expenditure	**35.8**	**35.1**	**34.4**	**34.6**	**34.2**	**32.4**
O/w interest payments	0.6	0.7	0.8	1.0	0.9	0.8
Primary balance	-2.1	-1.7	-1.8	-2.5	-2.6	-1.9
Overall balance	**-2.7**	**-2.5**	**-2.6**	**-3.5**	**-3.5**	**-2.7**
General government debt	**23.8**	**24.5**	**27.9**	**31.4**	**32.1**	**32.8**
% of general government revenue	71.9	74.8	87.6	101.1	104.4	110.4
General government deposits	1.0	0.5	3.0	3.8	2.6	2.7
Net general government debt	22.8	24.0	24.9	27.7	29.5	30.1
Central government						
Revenue	**31.3**	**30.4**	**29.7**	**31.1**	**30.7**	**29.7**
Expenditure and net lending	**33.9**	**35.1**	**32.2**	**34.6**	**34.2**	**32.4**
O/w current expenditure and transfers	32.6	32.2	31.5	31.6	-	-
- Interest	0.6	0.7	0.8	1.0	-	-
O/w capital expenditure	6.8	7.6	7.8	7.5	-	-
Current balance	-1.3	-1.8	-1.8	-0.6	-	-
Primary balance	-2.1	-4.0	-1.7	-2.5	-	-
Overall balance	**-2.7**	**-4.7**	**-2.5**	**-3.5**	**-3.5**	**-2.7**
Central government debt	23.8	24.5	27.9	31.4	32.1	32.8
% of central government revenues	76.1	80.4	94.0	101.1	104.4	110.4
Central government debt (MKDbn)	**97.8**	**106.3**	**128.9**	**149.6**	**162.4**	**178.9**
By place of issue						
Domestic	30.1	33.4	30.2	28.9	29.2	32.2
Foreign	67.6	72.9	98.7	120.7	133.2	146.7
By currency denomination						
Local currency	3.2	27.9	34.7	41.4	-	-
Foreign currency	94.5	83.7	95.1	106.6	113.6	123.6
In USD equivalent (eop exchange rate)	2.2	1.8	2.0	2.2	2.3	2.6
By maturity						
Average maturity (years)	**5.5**	**5.1**	**5.0**	**4.2**	**-**	**-**
Memo						
Nominal GDP (MKDbn)	410.7	434.1	461.7	476.1	506.0	545.7

Source: Ministry of Finance and Fitch estimates and forecasts

Figure 14
External Debt and Assets

(USDbn)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012f
Gross external debt	**2.3**	**2.8**	**3.0**	**3.3**	**4.2**	**4.7**	**5.4**	**5.6**	**6.4**	**6.7**
% of GDP	48.6	50.3	50.0	50.5	51.3	47.5	58.2	59.7	61.2	68.1
% of CXR	89.6	91.4	91.0	83.5	78.8	77.0	111.7	98.2	89.3	93.3
By maturity										
Medium- and long-term	1.9	2.2	2.3	2.6	2.8	3.4	4.0	4.2	5.0	5.3
Short-term	0.5	0.6	0.7	0.7	1.3	1.3	1.4	1.4	1.4	1.4
% of total debt	19.9	21.4	22.1	22.2	32.1	27.8	26.2	25.0	21.5	21.5
By debtor										
Monetary authorities	-	-	-	-	-	-	-	-	-	-
General government	**1.4**	**1.5**	**1.6**	**1.5**	**1.3**	**1.3**	**1.6**	**1.7**	**2.5**	**2.6**
O/w central government	-	-	-	-	-	-	-	-	-	-
Banks	**0.2**	**0.2**	**0.2**	**0.4**	**0.6**	**0.5**	**0.7**	**0.8**	**0.7**	**0.8**
Other sectors	**0.8**	**1.1**	**1.2**	**1.5**	**2.3**	**2.8**	**3.1**	**3.1**	**3.1**	**3.2**
Gross external assets (non-equity)	**1.8**	**2.1**	**2.5**	**3.3**	**4.1**	**3.6**	**3.9**	**4.2**	**4.6**	**4.8**
International reserves, incl. gold	0.9	1.0	1.3	1.9	2.3	2.1	2.3	2.3	2.7	2.9
Other sovereign assets nes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit money banks' foreign assets	0.7	0.8	0.8	0.9	1.0	0.6	0.7	0.8	0.8	0.8
Other sector foreign assets	0.2	0.3	0.4	0.6	0.8	0.9	0.9	1.1	1.2	1.2
Net external debt	**0.5**	**0.7**	**0.5**	**0.0**	**0.1**	**1.1**	**1.5**	**1.4**	**1.7**	**1.9**
% of GDP	10.1	12.0	8.2	-0.4	1.6	11.3	16.2	15.2	16.7	18.8
% of CXR	18.7	21.8	14.9	-0.7	2.5	18.3	31.0	25.0	24.4	25.8
Net sovereign external debt	0.4	0.5	0.3	-0.4	-0.9	-0.8	-0.7	-0.6	-0.2	-0.3
% of GDP	8.8	8.5	4.3	-6.2	-11.3	-8.2	-7.2	-6.6	-1.9	-2.8
Net bank external debt	-0.5	-0.7	-0.5	-0.5	-0.4	0.0	0.0	0.0	0.0	0.1
Net other external debt	0.6	0.9	0.8	0.9	1.4	1.9	2.2	2.0	2.0	2.0
Net international investment position	**-2.0**	**-2.5**	**-2.4**	**-2.5**	**-3.5**	**-4.6**	**-5.2**	**-4.9**	**-5.8**	**-6.1**
% of GDP	-42.0	-45.5	-39.4	-38.1	-43.4	-47.0	-55.6	-52.9	-55.4	-61.9
Sovereign net foreign assets	**-0.4**	**-0.5**	**-0.3**	**0.4**	**0.9**	**0.8**	**0.7**	**0.6**	**0.2**	**0.3**
% of GDP	-8.8	-8.5	-4.3	6.2	11.3	8.2	7.2	6.6	1.9	2.8
Debt service (principal & interest)	**0.3**	**0.3**	**0.2**	**0.6**	**0.5**	**0.4**	**0.3**	**0.7**	**0.5**	**0.6**
Debt service (% of CXR)	9.8	8.3	7.2	14.3	10.2	5.8	7.2	11.5	7.3	7.8
Interest (% of CXR)	2.1	1.7	1.8	2.3	2.5	2.2	2.1	2.2	2.5	2.5
Liquidity ratio (%)	396.5	225.9	217.8	168.4	215.0	187.6	161.4	145.0	159.0	179.0
Net sovereign FX debt (% of GDP)	20.4	18.9	11.8	0.7	-5.1	-3.6	-0.8	-5.1	-6.5	-7.0
Memo										
Nominal GDP	4.8	5.5	6.0	6.6	8.2	9.8	9.3	9.3	10.4	9.8
Gross sovereign external debt										
Inter-company loans	0.1	0.3	0.3	0.4	0.6	1.0	1.2	1.3	1.3	1.3

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

Figure 15
Debt Service Schedule on Medium- and Long-Term Debt at Date

(USDbn)	2011	2012	2013	2014	2015	2016
Sovereign	**75**	**306**	**208**	**445**	**148**	**138**
Official bilateral	12	11	10	10	10	10
O/w Paris Club						
Multilateral	64	72	198	243	137	127
O/w IMF			113	151	38	0
Bonds placed in foreign markets	0	223	0	191	0	0
Interest	59	56	61	60	52	48
Total sovereign debt service	**134**	**363**	**269**	**505**	**199**	**185**

Sources: Ministry of Finance and Fitch

Figure 16
Balance of Payments

(USDbn)	2009	2010	2011	2012f	2013f	2014f
Current account balance	**-0.6**	**-0.2**	**-0.3**	**-0.2**	**-0.3**	**-0.3**
% of GDP	-6.5	-2.1	-2.6	-2.2	-3.0	-2.6
% of CXR	-12.6	-3.5	-3.8	-3.0	-4.1	-3.6
Trade balance	**-2.4**	**-2.1**	**-2.7**	**-2.8**	**-2.9**	**-3.0**
Exports, fob	1.9	2.6	3.3	3.1	3.6	4.2
Imports, fob	4.3	4.6	6.0	5.9	6.5	7.2
Services, net	**0.3**	**0.2**	**0.5**	**0.4**	**0.5**	**0.6**
Services, credit	1.1	1.0	1.5	1.4	1.5	1.6
Services, debit	0.8	0.9	1.0	1.0	1.0	1.0
Income, net	**-0.1**	**-0.1**	**-0.2**	**-0.2**	**-0.1**	**-0.1**
Income, credit	0.2	0.2	0.2	0.2	0.3	0.3
Income, debit	0.2	0.3	0.4	0.4	0.4	0.4
O/w: Interest payments	0.1	0.1	0.2	0.2	0.2	0.3
Current transfers, net	**1.6**	**1.8**	**2.1**	**2.3**	**2.2**	**2.2**
Memo						
Non-debt-creating inflows (net)	0.0	0.2	0.5	0.1	0.2	0.3
O/w equity FDI	0.0	0.2	0.5	0.2	0.2	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)	-0.1	-0.1	-0.4	-0.2	-0.4	-0.5
Gross external financing requirement	0.9	0.7	0.6	0.6	1.0	0.7
Stock of international reserves, incl. gold	2.3	2.3	2.7	2.9	3.3	3.8

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.