Sovereigns
Macedonia
Special Report

Macedonia: An update on rating drivers

Ratings

	Current Ratings
Foreign Currency	
Long-Term IDR	BB+
Short-Term IDR	B
Local Currency	
Long-Term IDR	BB+
Country Ceiling	BBB+

Outlooks

Foreign-Currency Long-Term IDR	Negative
Local-Currency Long-Term IDR	Negative

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Related Research

- *External Financing Risks in Central and Eastern Europe (May 2009)*

Global Economic Outlook (March 2009)
Emerging Europe Growth Outlook (April 2009)
Emerging Europe Rating Dynamics (November 2008)
Rating Review of Emerging Markets (November 2008)
Credit Analysis Macedonia (December 2008)
Sovereign Rating Methodology (October 2007)

Summary

Fitch revised the Outlooks on Macedonia's foreign and local currency Issuer Default ratings ("IDR") to Negative from Stable on 21 May. The Outlook change reflects the risk that the deterioration in the global economic and financial environment will impose a costly macroeconomic adjustment on Macedonia, given its large current account deficit and fixed exchange rate regime. This report takes a closer look at Macedonia's external finances and reviews developments affecting other rating drivers.

External financing risks have been central to the stress placed on emerging markets by the global financial crisis. Countries with the largest imbalances, external repayment burdens and foreign currency debt on balance sheets are the most vulnerable to external financing risks. Fitch believes Macedonia is exposed to these risks and it may seek an IMF programme to help meet a potential financing gap and give a breathing space for necessary macroeconomic adjustments to take place.

Macedonia's current account deficit widened to almost 13% of GDP in 2008, compared with 7.5% in 2007 as the trade deficit increased. Fitch is forecasting that Macedonia's current account deficit will narrow only moderately to 10% of GDP in 2009 as it is being hit by negative shocks to the terms-of-trade, remittances and export market growth.

Although Macedonia's net external debt burden and stock of bank credit to the private sector is low compared to other Central and Eastern European countries, the economy is highly euroised with over half of loans and deposits denominated in or linked to foreign currency. Fitch believes high levels of euro- or US dollar denominated deposits speak to a potential fragility of confidence on the part of residents in their own currency. If local residents become concerned about the de facto peg of the Macedonian denar to the euro or the financial standing of the banks then they could switch savings into foreign currency and move assets offshore (capital flight), exacerbating pressures on the external finances and currency.

Macedonia's ratings continue to be underpinned by its moderate government debt burden (22% of GDP at end-2008, below the 'BB' range median of 35%), per capita income level of USD4,600 at market exchange rates that is higher than the 'BB' range median of USD3,600 and net public external creditor status. Furthermore, prudent fiscal policy has been a rating strength for Macedonia with the central government budget deficit averaging less than 0.2% of GDP in the five years to 2008 although likely deterioration in public finances will reverse this trend. Fitch is forecasting a central government budget deficit of 4.1% of GDP in 2009, above the government's target 2.8% of GDP deficit, as it is projecting that the economy will contract by 2% in 2009 (the government is forecasting growth of 1%).

Macedonia has been an official candidate for European Union membership since 2005. However, Fitch believes Greece's veto of Macedonia's application to become a NATO member due to its objection to the use of the country's name in 2008 could also make it harder for Macedonia to gain a starting date for European Union accession negotiations. Fitch believes NATO and EU membership remain important anchors for political stability in Macedonia as although ethnic tensions which led to internal armed conflict in 2001 have receded, there is potential for instability in

- The revision of the Outlook to Stable from Positive in November 2008 in part reflected Fitch's expectation that the starting date for EU accession negotiations was beyond the rating horizon.

neighbouring countries, including Kosovo. Macedonia's political situation remains a material consideration in its rating judgement.

External financing risks

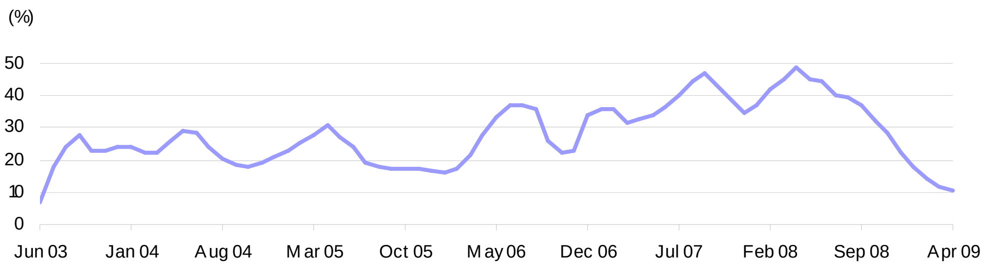
Current account re-balancing risk

Macedonia's current account deficit widened to almost 13% of GDP in 2008, compared with 7.5% in 2007 as imports continued to rise rapidly while the growth of both exports and remittances from Macedonian migrant workers slowed. The trade deficit rose from 21% of GDP in 2007 to 27% of GDP in 2008 as metals and textiles, both important exports for Macedonia, were hit hard by lower global commodity prices and the sharp decline in global trade in Q408.

Fitch is forecasting a moderate narrowing of Macedonia's current account deficit to 10% of GDP in 2009. The agency is projecting that a decline in workers' remittances and the slowdown in credit growth will lead to a slowdown in consumer demand and a sharp decline in imports. Remittances, which were equivalent to almost 15% of GDP in 2008, were 26% lower in the first two months of 2009. Coupled with remittances, credit growth has also helped fund consumer demand and import growth. Although credit growth remains high, it is slowing. Nominal year-on-year credit growth has fallen 21% in April 2009 from 34% in 2008 and 38% in 2007.

Slowdown in Credit Growth

Annualised rolling q-o-q

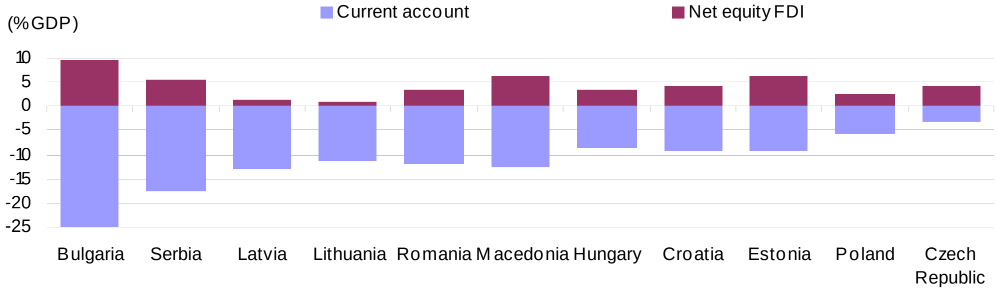


Source: National authorities and Fitch

However, the terms-of-trade shock, coupled with the depreciation of the flexible currencies of some countries in the region, suggest that external imbalances will be slower to correct: exports have fallen 43% year-on-year in Q109 while imports have fallen by 28% in the same period.

Current Account Balances and FDI

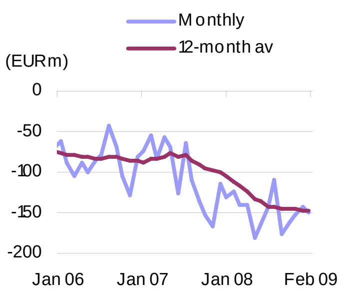
2008



Source: National Sources, IMF and Fitch

Current account rebalancing risk is compounded for countries with a low capacity to adjust (related to low trade openness, fixed exchange rates, and product and

Macedonian Trade Deficit



Source: Datastream and BNB

labour market inflexibility). Fitch has assessed Macedonia's economy as having a relatively low capacity to adjust to the shock to global capital flows, compared with other countries in Central and Eastern Europe.[1]

Gross external financing risk

The current account deficit is not the only potential source of pressure on the balance of payments, foreign reserves and currency - refinancing or rolling over existing maturing external debt payments is another source of external financing risk. Foreign direct investment (FDI) has been an important external financing item for Macedonia in recent years with flows covering the whole of the current account deficit in 2006 and 2007 and half of the current account deficit in 2008. However, Fitch expects foreign direct investment to fall sharply this year while the global credit crunch will make it more difficult for the private sector to borrow externally.

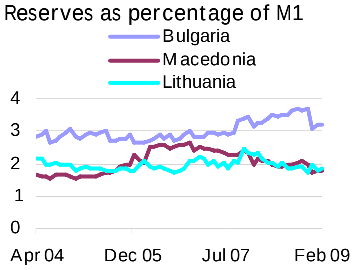
In its report entitled "External Financing Risks in Central and Eastern Europe", Fitch estimates external financing "gaps" for 2009 using available data on the structure of countries' external debt and debt maturities and its own assumptions on private sector rollover rates. Macedonia's gross external debt burden was USD4.7bn or 50% of GDP at end-2008, above the 'BB' range median of 34%. Slightly more than a quarter of the external debt stock is owed by the public sector. 61% of the debt is non-bank private sector, and only 12% belongs to the banking sector. Almost a fifth of total external debt is inter-company lending which has lower refinancing risk than market debt. Based on its current forecasts of Macedonia's current account deficit and financing (while acknowledging the uncertainty of the projections), Fitch's analysis suggests Macedonia could face an external financing gap of around USD0.6bn in 2009. This would be equivalent to a reduction of FX reserves by over a quarter from their end-2008 level.

- The de facto peg of the Macedonian denar to the euro has been in place since 1994 with a onetime devaluation of 16% undertaken in July 1997.

The National Bank of Macedonia had to intervene to sell EUR160m in Q408 after speculative pressure increased following the collapse of Lehman's. It has sold approximately EUR300m in the first five months of 2009 to defend the de facto peg to the euro, leading to a 21% fall in the stock of reserves since the beginning of the year to EUR1.2bn. Coverage of M1 by reserves was 1.7 in March 2009, down from 2.1 in March 2008. To safeguard reserves, the Central Bank raised the interest rate on Central Bank bills from 7% to 9% in March 2009. In May, the Central Bank raised banks' mandatory foreign currency reserve requirements to 13% from 10% and domestic currency reserve requirements to 20% from 10%. This policy stands in contrast to most central banks, which have been easing monetary conditions. This highlights the pressure the external finances are placing on the economy.

Peg Strength: M1

Reserves as percentage of M1



Source: Datastream, Fitch

The Macedonian authorities have appeared reluctant to approach the IMF for a programme as they repaid their last loan to the IMF in 2007. Fitch believes IMF support would be forthcoming if the government decided to seek a programme. Indeed an IMF press release of 15 May said: "The Fund stands ready to support Macedonia in whatever way is most helpful. The Fund is willing to discuss with the authorities the provision of technical assistance, policy advice, or financial support".

Foreign currency risk

Countries with the combination of a large net external debtor position or large banking systems and extensive FX lending look the most exposed to foreign currency risks. Although Macedonia's net external debt burden and stock of bank credit to the private sector is low compared to other Central and Eastern European countries, the economy is highly euroised with over half of loans and deposits denominated in or linked to foreign currency.

- Macedonia's net external debt position has deteriorated as the banking sector has run down its external assets and non-bank private sector debt has increased.

Net external debt was 11% of GDP at end-2008, up from 2% of GDP at end-2007 and above the 'BB' range median of 4% of GDP. The Macedonian banking system has been a substantial net external creditor for a number of years (to the tune of almost 5% of GDP in 2007). However, its net external creditor position was significantly eroded in 2008, reflecting the drawdown of deposits held abroad, and stood at almost zero at the end of the year. The sovereign remains a net external creditor, to the tune of 9% of GDP at end-2008, higher than the 'BB' range median of 2%. However, the non-bank private sector is a net external debtor.

Although credit has been growing at a fast pace in recent years, this has been from a low base and the stock of bank credit to the private sector was 43% of GDP at end-2008, one of the lowest in the region (although it is slightly higher than the 'BB' range median of 36%).

However, the Macedonian economy is highly euroised with approximately 55% of loans and 51% of deposits denominated in or indexed to foreign currency. The FX exposure underlines the problems that would be faced by the economy in the event of a devaluation (not Fitch's central scenario) and the authorities' commitment to maintaining the exchange rate peg.

Economic slowdown and public finances

Higher deficits planned

- Prudent fiscal policy has been a rating strength for Macedonia with the central government budget deficit averaging less than 0.2% of GDP in the five years to 2008.

Despite targeting a 1.5% of GDP central government budget deficit for 2008, the government ran a fiscal surplus of almost 3% of GDP in the first three quarters of 2008. In late 2008, the government passed a supplementary budget that increased both projected revenues and planned expenditures, retaining the 1.5% of GDP deficit target. Although revenues came in below target, expenditure plans were not realised in full and the central government budget deficit was 1% of GDP at end-2008.

Ahead of its June 2008 re-election, the government pledged to increase spending on public wages, pensions, agriculture and education as well as cutting social security contributions from 32% to 22% over three years. It pledged to increase the central government deficit to 2.8% of GDP in 2009 and 3% of GDP in 2010. The government's macroeconomic assumptions underpinning the 2009 budget were real growth of 5.5% and average inflation of 3.5%.

[1] See "External Financing Risks in Central and Eastern Europe", May 2009 www.fitchratings.com

- The growth rate of the Macedonian economy had picked up since 2006 with growth of 5.9% in 2007 and 5% in 2008.

Outlook for growth and inflation

The growth rate of the Macedonian economy slowed during 2008 to 2.1% year-on-year in Q408. The outlook for growth in 2009 is negative with industrial production 11% lower yoy in Q109 and exports down 43% yoy during the same period. Fitch is forecasting that the Macedonian economy will contract by 2% in 2009.

The inflation rate averaged 8.3% in 2008 as food and energy prices spiked and public and private sector wages and pensions were raised substantially (nominal wages grew by 10% in 2008). However, inflation is receding rapidly as commodity prices fall and the annual inflation rate was just 0.7% in February 2009. Fitch is forecasting an annual average inflation rate of 1% in 2009.

Budget revisions

In April 2009, the government cut its forecast for real growth in 2009 to 1% from 5.5% and revised central government revenue projections down but also cut expenditure so that the 2.8% of GDP deficit target would remain unchanged. Expenditure cuts were made by maintaining a public sector hiring freeze put in place in January 2009 ahead of local and presidential elections (a legal requirement), abolishing a 10% public sector pay rise planned for September 2009 and cutting expenditure on investment in the transport and defence sectors.

Fitch is forecasting a budget deficit of 4.1% of GDP on the basis of its assumptions that the economy will contract by 2% in 2009. The government, which usually does not spend all of its planned budget expenditure, has said that further expenditure cuts could be made in the autumn if revenues fell below target.

Budget financing

The Macedonian government plans to issue a EUR150-200m eurobond (approximately equivalent to 2.5-3% of GDP) to finance its budget deficit and debt maturities (external debt repayments are EUR96m in 2009). It is also planning the equivalent of 1.5% of GDP in net domestic issuance, double the volume of domestic issuance in 2008.

Political risk

- Macedonia's longstanding dispute with Greece over the former's official name resulted in Greece vetoing Macedonia's application for NATO membership in 2008.

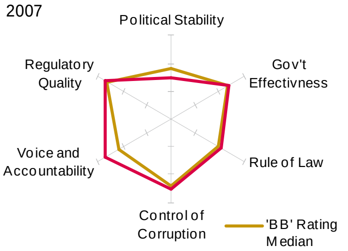
In Fitch's view, Macedonia's dispute with Greece could make it harder for it to gain a starting date for European Union accession negotiations, another important anchor for pro-reform sentiment as well as political stability. While resolving the name issue is not one of the official Copenhagen Criteria which need to be fulfilled before starting accession negotiations, the latest EU Progress Report on Macedonia (November 2008) states that "maintaining good neighbourly relations, including a negotiated and mutually acceptable solution to the name issue, under the auspices of the UN, remains essential".

As a NATO and EU member, Greece wields a veto over Macedonia's accession to both organisations. In December 2008, Macedonia took Greece to the International Court of Justice over the name issue and proceedings are expected to be lengthy. However, pro-EU sentiment remains strong in the government as well as the opposition. Macedonia's newly-elected President, George Ivanov, who was the candidate nominated by the ruling VMRO-DPMNE party, has spoken of his determination to find a solution to the name issue and put Macedonia's NATO accession bid back on track. Branko Crvenkovski, leader of the main opposition party, SDSM, has recently raised the possibility of unifying the opposition parties to renew efforts for NATO and EU membership.

The 2008 EU Progress Report for Macedonia stated that the country did not yet meet the Copenhagen political criteria for starting accession negotiations, largely

Governance Indicators

2007



Source: World Bank, Fitch

because early parliamentary elections held in June 2008 did not meet international standards according to OSCE-ODIHR election monitors. The report said Macedonia had "moved closer towards becoming a functioning market economy", one of the Copenhagen economic criteria for starting negotiations. The EU has described the conduct of the presidential and local elections held in April 2009 as "satisfactory" and said the focus now lay on reforming the judiciary and fighting corruption.