RESEARCH

Macedonia (Republic of)

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Major Rating Factors

Sovereign Credit Rating

Foreign Currency
BB+/Stable/B

Local Currency
BBB-/Stable/A-3

Strengths:

- EU candidate status providing an anchor for reforms and political stability
- Prudent macroeconomic policies reflected in stable growth, low inflation, and a good fiscal position
- Moderate external indebtedness

Weaknesses:

- Persistent structural rigidities reflected in a weak judicial system, low foreign investment inflows, and high unemployment, which weigh on economic performance
- Inflexible general government expenditure structure and inefficient social security system that pose a risk to fiscal prudence
- Residual latent, albeit declining, risk of interethnic tensions

Rationale

The ratings on the Republic of Macedonia reflect structural rigidities, labor market challenges, limited fiscal flexibility, and residual political tensions among political parties. They are supported, however, by prudent macroeconomic policies underpinned by stable economic growth, sound fiscal results, and the implementation of comprehensive structural reforms. Moreover, the ratings also reflect sustained progress on political stability, supported by prospects for EU accession.

Structural expenditure rigidities and inefficient social security and health care systems limit fiscal flexibility. The center-right government that emerged from the July 2006 elections, however, is bringing a new rigor to market-friendly reforms and deregulation, including the "regulatory guillotine" and tax reforms.

Fiscal consolidation, debt repayments, and stable economic growth are forecast to continue lowering general government debt to 30% of GDP by 2009, from an estimated 34% in 2006.

The commitments under the Ohrid Framework Agreement (OFA) that ended the 2001 security crisis have largely been fulfilled, while the political environment has improved. As minority rights have been extended, interethnic violence is unlikely, especially in the context of Macedonia's aspirations to join the EU and ongoing government reforms. The current government is expected to work toward further EU integration and improvement in interethnic relations, notwithstanding the recent parliamentary boycott by the largest Albanian party (which may delay the passage of legislation that requires votes from major ethnic Albanian parties). Although EU candidate status offers prospects for EU accession only toward the middle of the next decade, EU membership ambitions will remain an important driver of reforms.

Outlook

The stable outlook reflects Standard & Poor's expectation that the government will pursue sustained and tangible progress in continuing implementation of structural reforms, and that macroeconomic stability and fiscal prudence will be maintained. Furthermore, the outlook is based on the assumption of continued normalization of interethnic relations among political parties. Under this scenario, both economic and the institutional frameworks would become more robust and resilient to adverse shocks, which could eventually lead to the foreign currency ratings being raised to investment grade.

Standard & Poor's Ratings Services does not expect a starting date for EU accession talks to be set before 2009, as enlargement fatigue has set in among the incumbent member states. An acceleration of this projected timeline to an earlier date would strengthen reform incentives and act as a positive credit factor.

Conversely, any significant departure from the consensus to pursue and implement important structural reforms and prudent macroeconomic policies, or a significant deterioration of political stability and interethnic relations, could put the ratings under downward pressure.

Table 1

Republic of Macedonia Selected Indicators

	2009f	2008f	2007f	2006	2005	2004	2003	'BB' Median 2007f
GDP per capita ($)	3,526	3,320	3,106	3,042	2,829	2,637	2,278	2,941
Real GDP (% change)	4.5	4.5	4.3	4.0	4.0	4.1	2.8	5.8
Real GDP per capita (% change)	4.1	4.3	4.1	3.8	3.8	3.9	2.3	4.2
General government balance (% of GDP)	(0.8)	(1.3)	(1.0)	(0.6)	0.2	0.4	(0.6)	(1.2)
General government debt (% of GDP)	30.3	31.4	32.3	33.7	40.2	36.6	39.1	40.5
Net general government debt (% of GDP)	25.5	24.9	24.1	21.2	30.8	31.0	32.9	32.8
General government interest expenditures (% of revenues)	2.2	2.2	2.3	2.3	2.8	2.6	3.2	11.0
Domestic credit to private sector and NFPEs (% of GDP)	42.8	38.7	34.5	31.1	26.1	23.4	20.0	37.5
CPI (average % change)	2.0	2.5	3.5	3.2	0.5	(0.4)	1.1	4.8
Gross external financing needs (% of CARs and usable reserves)	81.9	82.8	82.4	85.3	89.5	98.0	94.2	83.7
Current account balance (% of GDP)	(4.1)	(4.2)	(3.5)	(0.7)	(1.4)	(7.7)	(3.2)	(0.8)
Narrow net external debt (% of CARs)*	(8.1)	(7.7)	(5.5)	(9.2)	4.8	7.5	10.7	24.3

*Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. f--Forecast. NFPEs--Nonfinancial public enterprises. CARs--Current account receipts.

Comparative Analysis

- As for its Balkan peers, the prospect of EU membership remains the key driver of economic reform and political stability in Macedonia.
- Macedonia's sustained economic growth, low inflation, and low fiscal deficits compare well with peers.
- External liquidity is moderate and on a par with the 'BB' median, but income and unemployment levels compare unfavorably with peers.

Macedonia's peers include three in the Balkan region: the Republic of Montenegro (BB+/Stable/B; all references to ratings hereafter are to foreign currency sovereign credit ratings); the new EU entrant Republic of Romania (BBB-/Stable/A-3), and the Republic of Serbia (BB-/Positive/B). Outside the region, the Republic of Peru (BB+/Stable/B) and the Republic of El Salvador (BB+/Stable/B) provide useful comparison.

EU main driver for reforms

One important characteristic of the policy environment that Macedonia shares with its regional peers, including the Republic of Croatia (BBB/Stable/A-3) but excluding Romania, is the pursuit of prudent macroeconomic policies and ongoing economic reforms aimed at achieving eventual EU membership.

The EU remains an important driver of, and policy anchor for, reforms for the regional peers, although they are at different stages on their way toward EU membership. Macedonia was awarded EU candidate status in December 2005, thereby joining Croatia, which is a candidate country. Although actual membership negotiations for Macedonia are still awaiting a green light from the EU, they are well under way for Croatia. Romania and the Republic of Bulgaria (BBB+/Stable/A-2) entered the EU in January 2007.

Montenegro and Serbia opened talks on Stabilization and Association Agreements with the EU in November 2005, which is the first important step on the still long road toward EU membership. Although the EU postponed talks with Serbia in May 2006, due to its incomplete cooperation with the Hague Tribunal, this is unlikely to have a long-term impact on Serbia's EU accession prospects, given that full cooperation with the tribunal by a reform-oriented government is under way. The talks are expected to start in mid June 2007. Montenegro has more momentum toward EU integration, boosted by the enthusiasm surrounding the country's recently gained independence.

Macedonia's coalition government remains more stable than that of Serbia or Romania, but lags that of Montenegro, where the ruling parties take considerably less time to reach consensus among coalition partners on important economic and political issues. In Romania, national institutions are still weak, but EU membership offers the possibility of faster convergence toward EU levels.

Montenegro's strong policy consensus to use the euro is similar to the situation in El Salvador, which uses the U.S. dollar as legal tender. This compares favorably with the situation in Macedonia, where large foreign currency inflows pose a challenge to monetary policy. Like Peru, Macedonia has a growing consensus on macroeconomic policies, although the risk of policy reversal is more pronounced in Peru owing to widespread social and ethnic divisions. The prospect of EU membership helps generate support for these reforms among a wider political spectrum in Macedonia, however, owing to closer European links.

In all regional peers, the road to accession includes the passage of legislation geared to EU membership requirements through preaccession agreements. It is necessary for prospective members to bring their legislation and institutions in line with EU requirements and fulfill the "acquis communautaire," the total accumulated body of EU law. The experience of the EU members that have joined since 2004 demonstrates that the prospect of EU membership can serve as a very powerful anchor for economic reforms and prudent policies, and is likely to support further rating improvements. In order to progress further with EU integration, Macedonia needs to strengthen its judicial system, improve the administrative capacity of its institutions, and ultimately strengthen its political climate.

Income amongst lowest in peer group, but economic growth accelerating
Income levels in Macedonia are lower than regional peers, in particular lagging behind Croatia and Romania. Macedonia's per capita income levels, at $3,106 in 2007, are higher than the 'BB' median, but are at the bottom of the peer group with the exception of El Salvador (see chart 1). The higher income levels in Serbia and Montenegro are largely due to a somewhat more favorable economic structure inherited from the Yugoslav period and a rapid catching-up process. Macedonia was one of the poorest regions in the former Yugoslavia. Its growth prospects, at an average of 4.5% in the medium term, are slowly catching up with those of its peers and the 'BB' median (see chart 2). This is an important for Macedonia because it will avoid further widening of the relative wealth gap, as growth in previous years has fallen short of that in peers, partially as a result of the security crisis in 2001.

Chart 1

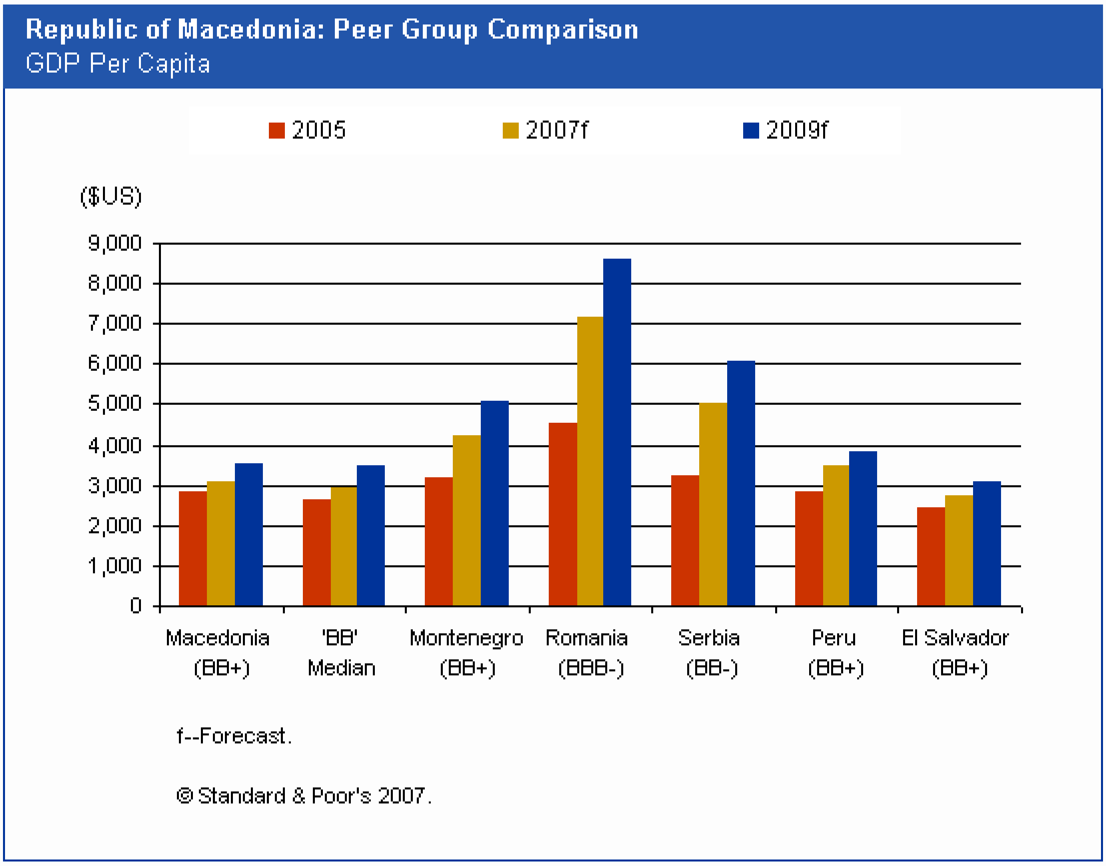
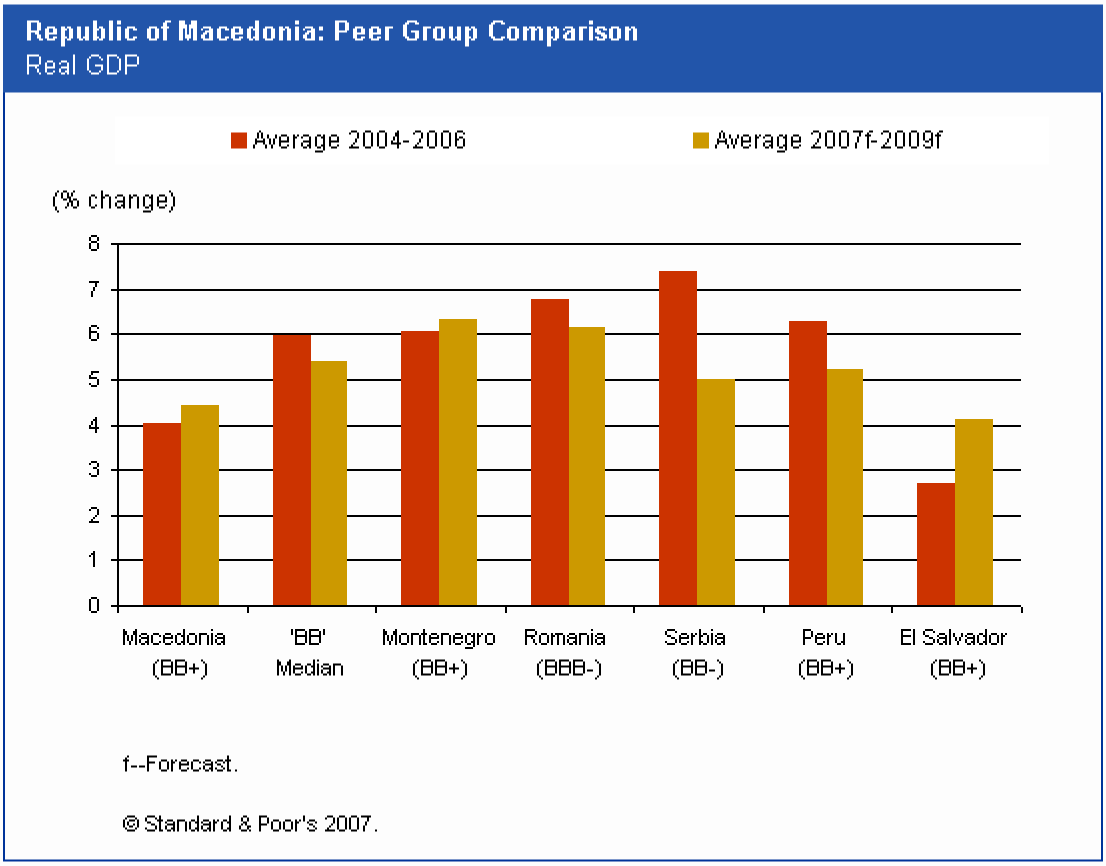


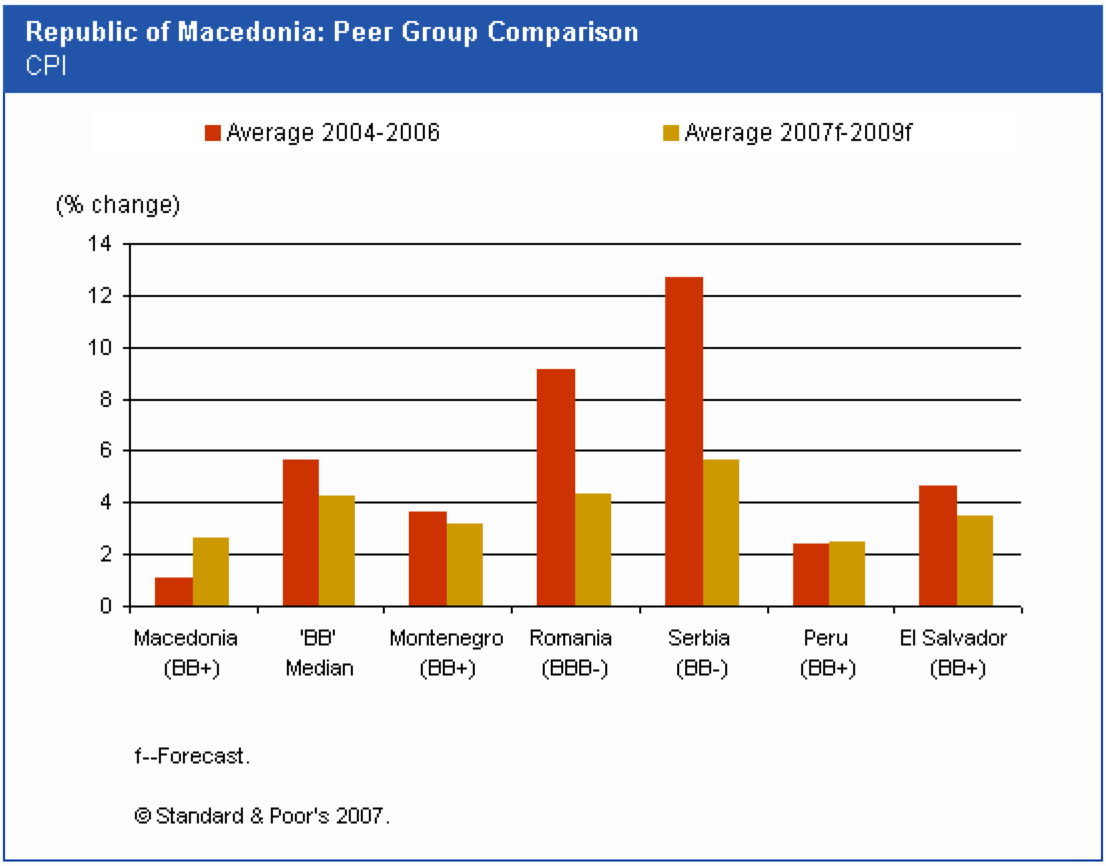
Chart 2



Prudent policies promote sound fiscal results and low inflation

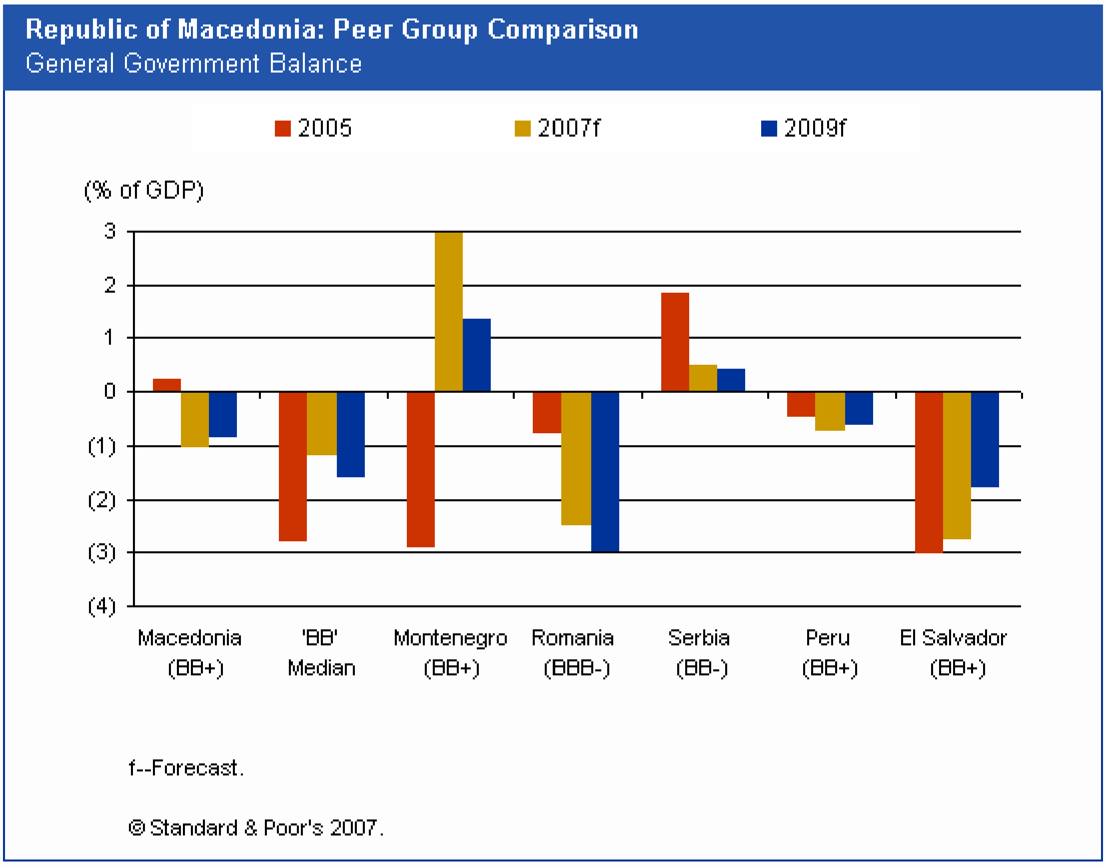
The introduction of a fixed exchange rate, pegged to the euro, in the mid-1990s has enabled the maintenance of low inflation rates in Macedonia, below levels in all peers, including Bulgaria, which has adopted a currency board, or Montenegro, which uses the euro as legal tender (see chart 3). By contrast, inflation in Serbia has been much more persistent, still reaching 7% in 2006 after double digits in 2005.

Chart 3



Macedonian authorities have also managed to maintain tight fiscal policies, as is evident from a deficit in 2006 of 0.6% of GDP and expectations of fiscal deficits thereafter at about 1.0% of GDP (see chart 4). By comparison, fiscal results are better in Montenegro, which embarked on an ambitious consolidation program, and in Serbia, where the government follows a policy of targeting a broadly balanced budget. In 2006, the 'BB' median posted an average deficit of 1.1%.

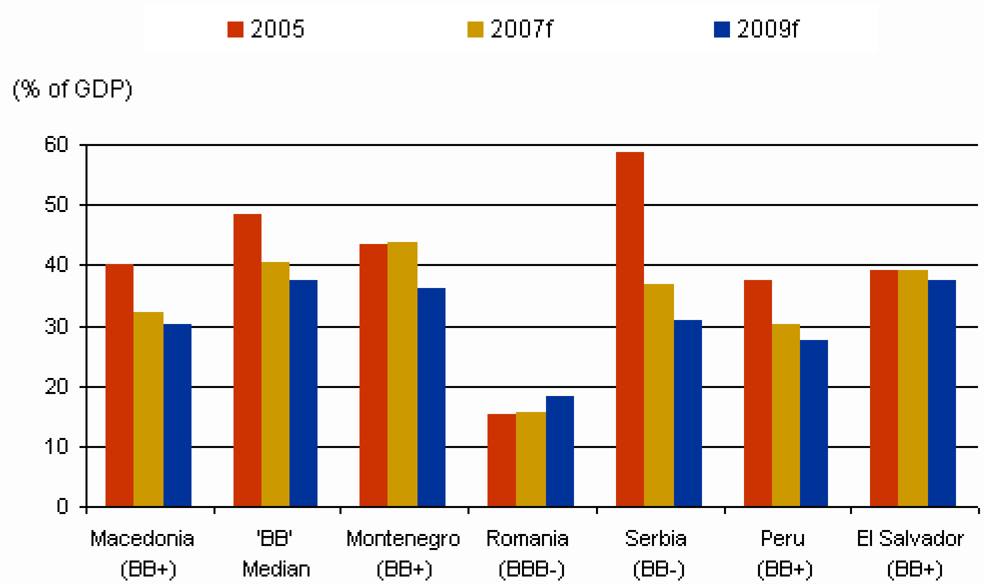
Chart 4



As a result of relatively low financing requirements due to the small budget deficit, and financial support through external grants and subsidized loans, general government debt in Macedonia in 2006 is moderate, well below the 'BB' median of 34% of GDP, and higher only than in Romania and Peru. Debt will continue to trend down, in line with all peers, to reach 32.3% in 2007 (see chart 5). This decline will be less pronounced than in Serbia, however, which benefits from stronger growth and a more favorable fiscal position.

Chart 5

Republic of Macedonia: Peer Group Comparison
General Government Debt

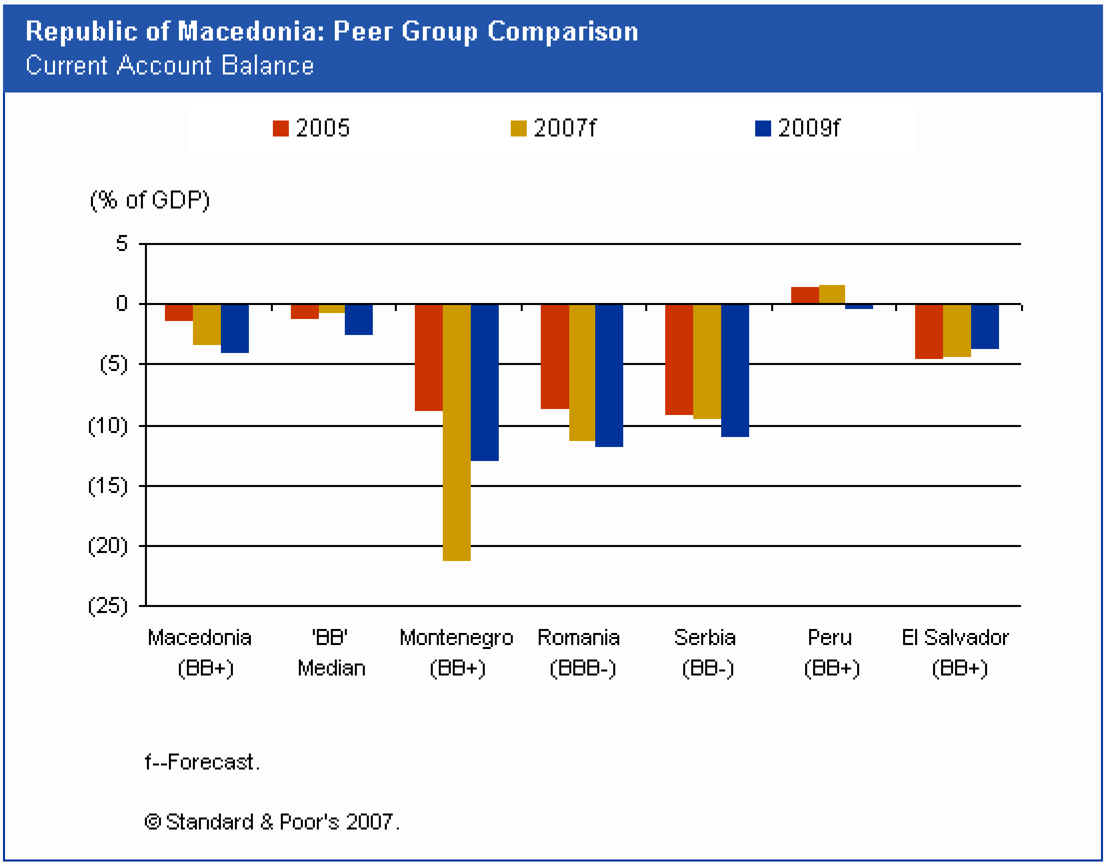


f--Forecast.

External liquidity requirements moderate
Like regional peers that are catching up with the EU in terms of economic development and structure, Macedonia has a sizable trade deficit, at 20.7% of GDP in 2006, reflecting high capital goods import requirements. This is analogous with peers, particularly Montenegro and Serbia, where deficits of 19% and 48% were registered.

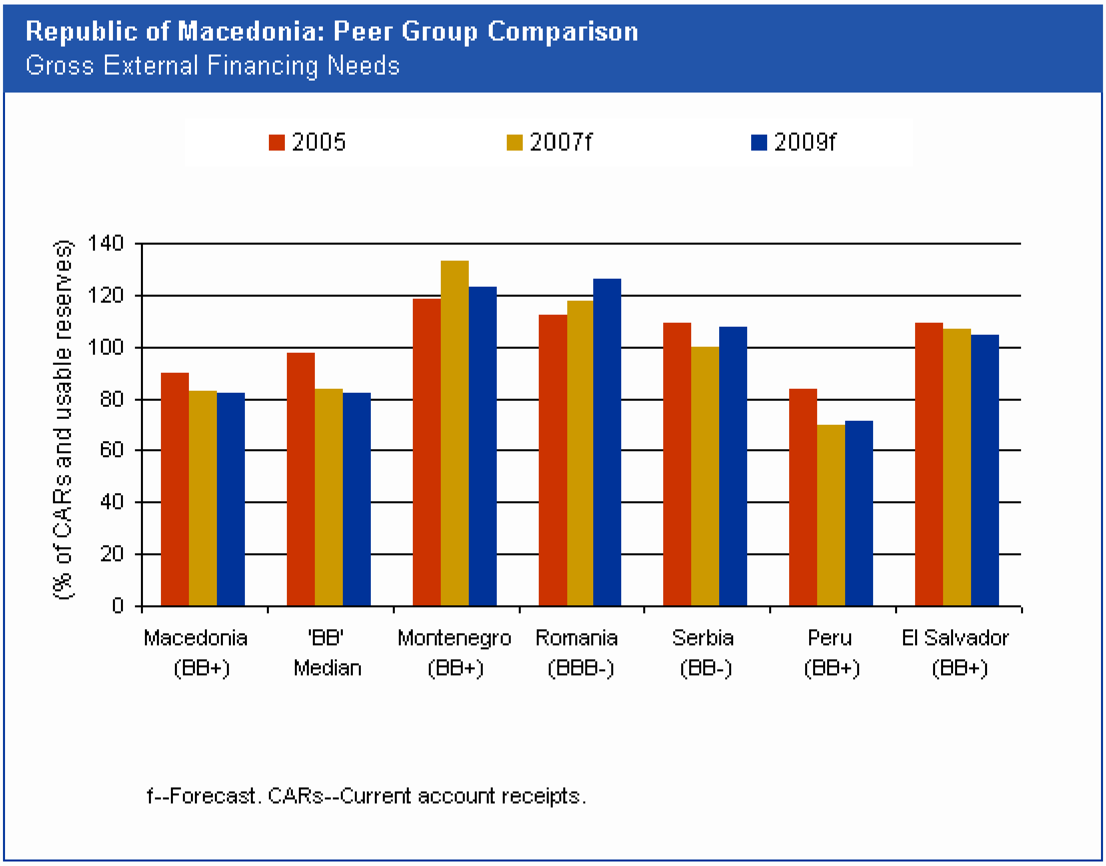
For regional peers, the impact of the trade deficit on the current account balance has been dampened by factors such as considerable official transfers and consistently large private transfers (mainly remittances), which provide current account relief. As a result, current account deficits in Macedonia are generally lower than in Serbia, Romania, and Montenegro (see chart 6). Extremely strong levels of foreign direct investment (FDI) in Montenegro, however, mainly stemming from thriving investment in real estate and tourism sectors, fully counter the gargantuan current account deficits.

Chart 6



After historically large deficits, Macedonia's current account balance significantly improved in 2006, with the deficit estimated at 0.7% of GDP, mainly due to the recovery of exports, higher-than-expected private transfers, and nonpayment of the telecommunications dividend (see "Fiscal Flexibility: Fiscal Consolidation On Track" below). Moreover, gross external financing needs are estimated at 82.4% of current account receipts (CARs) in 2007, less than those of peers, except for Peru (see chart 7). This difference is due to external grants that partially finance the trade deficit, and to a favorable external debt repayment structure.

Chart 7



Political Environment: EU Membership Remains Main Goal

- Eventual EU membership is a key driver of reform, but a weak judicial system and inefficient public administration are obstacles.
- EU accession talks will be secured only when political dialogue is fully restored between the government and the main ethnic Albanian party.

The ruling coalition comprises the largest reformist party, the Internal Macedonian Revolutionary Organization-Democratic Party of Macedonian National Unity (VMRO-DPMNE), whose rise to power was the principal change in the composition of parliament after the general election, the Democratic Party of Albanians, and other smaller parties. The largest Albanian opposition party--the Democratic Union for Integration (DUI)--was excluded from the ruling coalition.

The coalition is strongly focused on the requirements of EU membership, as demonstrated by the amount of new legislation being passed. The new government has a strong focus on obtaining a date for accession talks with the EU in 2008. Standard & Poor's does not expect a starting date for EU accession talks before 2009, as enlargement fatigue has set in among the incumbent member states.

Although the ruling coalition has a full majority in the parliament, there is a risk that reforms might be delayed if the passage of important laws continues to be affected by the recent parliamentary boycott by the DUI. This may compromise the government's ability to proceed with the implementation of OFA and comply with the political criteria required by the EU. The government and the boycotting party have, however, concluded an agreement to restore political dialogue, which enables the opposition to rejoin the parliament. The strong policy anchors provided by EU candidacy status enable the new government to remain firmly on track.

The implementation of the OFA has markedly improved minority rights and allowed for increased ethnic Albanian representation in public administration through the decentralization of power to local governments since summer 2005. So far, this process has been successful, allowing the budgets of local administrations to be more flexible with regard to the use of their own revenues. Nevertheless, the "Badinter principle" of the OFA prevents certain laws being passed without a majority of votes from all ethnic parties, including ethnic Albanian ones. The lack of cooperation and political consensus between the DUI and the ruling coalition between September 2006 and June 2007 revealed the limitations of the efficacy of government, but there has been noteworthy progress toward re-establishing political dialogue between these parties.

Although interethnic relations will continue to play an important role in Macedonian politics, renewed ethnic conflict that could undermine political stability is unlikely. The OFA has broad political support among Macedonian citizens, and there is a general perception that both ethnic groups have ultimately benefited from it. Certain radical elements in Macedonia may still promote secession along ethnic lines, but these ideas no longer resonate with the broad public. Moreover, political stability in the country has improved significantly, and NATO membership is expected in 2009. Nevertheless, regional political risk remains considerable in light of the pending decision of the U.N. Security Council on Kosovo, and therefore may still provide impetus for radical forces in Macedonia. The common goal of EU membership will continue to be the most important anchor for ongoing reform efforts and political stability.

Economic Prospects: Growth Sustained, But Weaknesses Remain

- GDP growth is forecast at about 4.5% in the medium term but continues to be hampered by institutional constraints, low FDI inflows, and high unemployment.
- Further progress on structural reforms is crucial to improve institutional weaknesses, in particular an inefficient judicial system and a poor business climate.

Table 2

Republic of Macedonia Economic And Financial Indicators

	2009f	2008f	2007f	2006	2005	2004	2003
Nominal GDP (bil. MKD)	374.1	350.9	327.6	303.5	284.4	265.3	251.5
Nominal GDP (bil. $)	7.3	6.8	6.4	6.2	5.8	5.4	4.6
GDP per capita ($000s)	3.5	3.3	3.1	3.0	2.8	2.6	2.3
Real GDP (% change)	4.5	4.5	4.3	4.0	4.0	4.1	2.8
Real GDP per capita (% change)	4.1	4.3	4.1	3.8	3.8	3.9	2.3
Real domestic demand (% change)	4.2	3.7	4.3	1.6	2.9	7.0	0.1
Real investment (% change)	9.0	9.0	8.0	6.5	6.4	9.6	5.0
Gross domestic investment (% of GDP)	20.4	19.6	18.8	18.5	18.1	20.5	20.0
Gross domestic savings (% of GDP)	16.3	15.4	15.3	17.8	16.7	12.7	16.8
Real exports (% change)	6.0	6.0	6.0	7.0	7.8	9.0	4.0
Unemployment rate (average claimant count; %)	28.0	30.5	33.5	35.9	36.2	37.2	36.7
Consumer price index (% change)	2.0	2.5	3.5	3.2	0.5	(0.4)	1.1

Domestic credit to private sector and NFPEs (% change)	17.9	19.9	19.9	27.4	19.2	23.3	14.8
Domestic credit to private sector and NFPEs (% of GDP)	42.8	38.7	34.5	31.1	26.1	23.4	20.0

f--Forecast. MKD--Macedonian denar. NFPEs--Nonfinancial public enterprises.

Economic structure

Macedonia is a small and moderately diversified economy with steel and textiles manufacturing as its leading sectors. GDP per capita is estimated at $3,106 in 2007, and will exceed $4,000 only after the end of the current decade. Reported national income statistics on Macedonia, however, should be treated with caution.

Unemployment in Macedonia is high, at an estimated 36% in 2006, in spite of 4.3% employment growth. This is partially due to the rigid structure of the labor market inherited from the former Yugoslav regime, but mostly due to generous benefit schemes. Inefficient institutions and a poor business climate also exacerbate unemployment. The 2006 National Strategy for Employment and a reduction in personal income tax to a flat rate of 12% should address some of the labor market rigidities and provide more flexibility by, for example, allowing the use of part-time contracts. This, accompanied by a one-stop shop for business registration, is expected to enable a gradual decrease in unemployment.

The level of foreign investment remains low. It will fall back to 3% of GDP in 2007, following a one-off rise to 6% of GDP in 2006 due to power utility privatization. Obstacles to investment (both foreign and domestic) include above all an inefficient judicial system and sizable administrative hurdles. To facilitate investment, government has initiated comprehensive judicial reforms aimed at ensuring the independence of the courts and removing administrative barriers. Moreover, the government's 2006 "regulatory guillotine" aims at removing administrative hurdles in order to improve the business climate.

Prudent macroeconomic policies, underpinned until August 2008 by a three-year IMF standby precautionary program, are expected to support structural reforms and ensure fiscal sustainability in the medium term. The program also focuses on labor market and judicial reform measures. Preaccession funds from the EU from 2007 are expected to address the structural weaknesses.

Economic growth

In 2002-2004, the economy slowly recovered from the security crisis in 2001, with average GDP growth of 2%. After 2004, however, real GDP growth was estimated at 4% annually, including 2006, an acceleration that was mostly underpinned by recovery in the iron and steel industry and increasing investment as political risk receded.

In the medium term, real GDP growth is expected to oscillate around 4.5% per year, compared with 4.0% in 2007. This is due to stronger foreign investment and government consumption, the latter reflecting higher capital investment in infrastructure, as the government continues to tackle major structural weaknesses. The further sale of telecoms shares should also bring in substantial flows of foreign investment, while banking services and telecoms are expected to grow quite rapidly in the medium term.

Fiscal Flexibility: Fiscal Consolidation On Track

- The general government deficit of 0.6% of GDP in 2006 is expected to increase to 1.0% in the medium term.
- Net general government debt continues to decline, to a forecast 21% of GDP in 2006.

Table 3

Republic of Macedonia Fiscal Indicators

(% of GDP)	2009f	2008f	2007f	2006	2005	2004	2003
General government revenues	32.9	33.0	33.2	34.3	35.5	30.3	34.5
Of which central government	19.4	19.4	21.8	22.9	24.4	21.5	21.4
General government expenditures	33.8	34.3	34.2	34.9	35.2	29.9	35.1
Of which central government	20.0	20.3	22.6	23.2	23.9	20.7	22.6
General government balance	(0.8)	(1.3)	(1.0)	(0.6)	0.2	0.4	(0.6)
Of which central government	(0.6)	(1.0)	(0.9)	(0.3)	0.5	0.8	(1.1)
Of which local authorities	0.0	0.0	0.0	0.0	0.0	0.1	0.1
General government primary balance	(0.1)	(0.5)	(0.3)	0.2	1.2	1.2	0.5
Central government primary balance	0.1	(0.2)	(0.1)	0.6	1.3	1.6	(0.2)
General government balance (% of revenues)	(2.6)	(3.8)	(3.1)	(1.6)	0.7	1.5	(1.8)
General government interest payments (% of revenues)	2.2	2.2	2.3	2.3	2.8	2.6	3.2
Central government interest payments (% of revenues)	3.6	3.7	3.4	3.9	3.4	3.6	4.5

Public sector gross debt	33.3	34.6	35.6	37.7	44.4	40.9	43.3
Of which general government debt	30.3	31.4	32.3	33.7	40.2	36.6	39.1
Of which central government debt	29.7	30.9	32.1	33.7	40.2	37.0	39.1
Public sector net debt	28.5	28.1	27.4	25.1	35.0	35.2	37.1
Of which general government net debt	25.5	24.9	24.1	21.2	30.8	31.0	32.9
Of which central government net debt	24.9	24.4	23.9	21.2	30.8	31.3	32.9

f--Forecast.

Revenue, expenditure, and balance performance

The general government recorded a deficit of 0.6% of GDP in 2006. The shortfall in revenues--mainly owing to the delayed payment of a telecoms dividend, owing to internal investigative procedures at the parent company, Magyar Telekom PLC (A-/Negative/--)--was offset by lower-than-budgeted expenditures due to a shortfall in capital spending (about 80% of projects were implemented). Expenditure flexibility remains limited, with wages and transfers to social funds accounting for at least 70% of all general government expenditure. The government remains strongly committed to restructuring revenues and expenditures, in line with IMF program requirements.

The 2007 budget will target further tightening of current expenditures and social transfers, but lower revenues are expected, mainly due to reductions in personal income tax and corporate tax to a flat rate of 12% in 2007 from previous progressive rates of 15%-24%. Under this scenario, the general government deficit is forecast at 1% of GDP in 2007. The main risk of a wider deficit in the medium term (more than 1% of GDP) stems from expenditure, particularly the inefficient health care system and capacity constraints that prevent the full absorption of spending, execution of capital investments, and possible cofinancing with EU funds.

The decentralization of responsibilities should be completed by 2009, with about 20% of central government revenues redistributed to the local government level. Most of the local governments' expenditures, particularly wages, still go through the national treasury, which will also monitor their performance, as local government deficits are not permitted.

The government's reforms have continued to improve the country's highly inefficient health care insurance system. A fully funded second-pillar pension scheme was introduced, which is mandatory for entrants to the labor market in 2003 and after. The pension reform has set the retirement age for men at 64 and for women at 62 years, with 15 years of minimum service required. The cost of the pension reform is estimated at 0.2% of GDP in 2006. The government also needs to tackle the inefficient energy sector.

Government debt and interest burden

Fiscal discipline and debt buybacks have reduced general government debt to an estimated 34% in 2006, and are forecast to decline further to 32% in 2007, from 40% of GDP in 2005. Foreign creditors hold 90% of Macedonian debt, mostly denominated in euros. The government's use of privatization proceeds--particularly in the telecoms sector--has contributed significantly to the decline in debt.

The general government continues to have low interest payments, at an estimated 2.3% of revenues in 2006, reflecting the concessional terms on much of the government debt, mainly owed to bilateral and multilateral lenders.

In 2005, the government issued the first international bond of €150 million, maturing in 2015. The proceeds from the Eurobond have been used for the refinancing of existing financial obligations to the London Club of creditors ($200 million in Brady bonds were redeemed). Standard & Poor's assigned a recovery rating of '2', indicating recovery prospects in the range of 80%-100%, to Macedonia's long-term foreign currency debt and raised the debt rating by one notch to 'BBB-' with a stable outlook from 'BB+' (see "Standard & Poor's Speculative-Grade Sovereign Debt Recovery Ratings," published on RatingsDirect, on June 12, 2007).

The government issued three-year Macedonian denar-denominated government securities in 2006 (including one-off central bank bills for monetary purposes), with a view to shifting the structure of government debt more toward local debt markets, and to promoting the development of domestic capital markets. In that context, a five-year government securities issuance is planned for 2007.

Off-budget and contingent liabilities

The share of central government guarantees remains low, estimated at about 3.0% of GDP. The external debt of public enterprises totaled 2.9% of GDP in 2006 (mainly owed by the railways and the power utility), while borrowing by the Macedonian Bank for Development Promotion, the only remaining public sector financial institution, is negligible, at 0.5% of GDP. Macedonia's banking system poses a modest contingent liability to the government.

Monetary Policy: The Challenge Of Sterilizing Inflows Persists

- Inflation rose to an estimated 3.2% in 2006, but is expected to peak at 3.5% in 2007, before dropping to 2% in the medium term.
- The local currency is pegged to the euro but large foreign currency inflows pose a challenge to monetary policy in the medium term.

The fixed exchange rate of the Macedonian denar to the euro (previously the German mark) has been a successful nominal anchor since 1995. The National Bank of Macedonia (NBM) has managed to maintain a stable nominal exchange rate to the euro, with pressure for nominal appreciation recently partially assuaged by the depreciation of the U.S. dollar. After deflation of 0.4% in 2004, and low inflation of 0.5% in 2005, when price pressures were subdued by the significant drop in import tariffs on food and agricultural products due to accession to the World Trade Organization, inflation significantly increased to 3.2% in 2006. This was mainly due to an increase in utility and tobacco prices (in line with EU requirements), and higher international oil prices. The medium-term forecast suggests inflation will peak at 3.5% in 2007, before it drops to 2.0% in the medium term.

Large inflows of foreign exchange continued in 2006 (as reflected in the high liquidity of the banking sector), which enabled NBM to increase international reserves to $1.8 billion in 2006, from $0.9 billion in 2004. To preserve exchange rate stability and low inflation, in addition to maintaining banking sector reserves at the required levels and mopping up excess liquidity, the NBM has introduced central bank bills for monetary purposes, which are traded via a central treasury (about 2% of GDP). These bills have been issued through regular three-month market-led auctions, with the average monthly interest rate falling to 5.5% in April 2007 from 6.0% in 2005. In the short to medium term, sterilization is expected to remain a challenge for NBM, due to prospective further privatization inflows. Small and manageable projected fiscal deficits should also assist coordination with monetary policy.

Banking privatization is almost complete, with 93% of banking sector assets in private hands. Competition remains limited as the three largest banks dominate the market, but the new banking law allowing foreign bank branches is expected to provide stronger competition. The banking legislation aims to strengthen supervision of the sector and ultimately boost competition.

The Macedonian banking sector continues to be highly euroized, with more than 60% of all deposits denominated in foreign currency. Most new lending to private companies and households is also in foreign currency as financial sector intermediation increases. NPLs are still high, at 12% in 2006, but down from a very high 27% of total loans in 2005, still reflecting the risky operating environment. Domestic credit as a proportion of GDP is estimated at 31% in 2006, up from 23% in 2004, reflecting still low financial intermediation. Average lending interest rates remain high, at an estimated 11% in 2006.

External Finances: Moderate External Imbalances

- External financing needs remain moderate.
- The financial sector continues to be a net external creditor.
- The public and private nonfinancial sectors are moderate external debtors.

Table 4

Republic of Macedonia External Indicators

	2009f	2008f	2007f	2006	2005	2004	2003
(% of GDP)							
Current account balance	(4.1)	(4.2)	(3.5)	(0.7)	(1.4)	(7.7)	(3.2)
Trade balance	(20.7)	(21.0)	(21.8)	(20.7)	(18.3)	(20.7)	(18.3)
Net foreign direct investment	2.6	4.7	3.1	5.6	1.7	2.9	2.1
(% of CARs)							
Current account balance	(5.8)	(6.0)	(4.8)	(1.0)	(2.2)	(13.8)	(5.9)
Net external liabilities	35.3	35.0	32.3	26.6	37.0	43.9	46.7
Total external debt	54.7	56.9	56.3	52.1	60.3	67.7	74.2
General government external debt	31.3	34.1	34.6	31.2	39.5	45.3	50.3
Narrow net external debt*	(8.1)	(7.7)	(5.5)	(9.2)	4.8	7.5	10.7
Net public sector external debt	(15.8)	(13.6)	(9.6)	(11.8)	4.7	13.9	14.4
Net nonbank private sector external debt	17.3	16.9	16.1	15.6	15.2	14.9	14.2
Net banking sector external debt	(10.0)	(11.4)	(12.5)	(13.4)	(15.5)	(21.8)	(19.6)
Net investment payments	1.2	1.1	1.9	0.1	1.5	1.3	1.3
Net interest payments	1.2	1.2	1.7	0.6	0.7	0.9	1.2
Reserves/CAPs (months)	5.1	4.9	4.7	3.7	3.1	3.3	3.5

Gross external financing needs (% of CARs and usable reserves)	81.9	82.8	82.4	85.3	89.5	98.0	94.2

*Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. f--Forecast. CARs--Current account receipts. CAPs--Current account payments.

External liquidity

In 2006, the current account deficit was estimated at 0.7% of GDP compared with 7.7% in 2004. This is a significant decline, mainly due to a recovery in metal industry exports, lower imports, and higher inflows of private transfers. Deficits are forecast to increase slightly from 2006 to an average of 4.0% in the medium term, after an average of 7.0% in 2001-2004, owing to stronger imports and expected payments of the telecoms dividend. Net foreign direct investment, which averaged 2.3% of GDP in 2002-2004, is expected to increase its role in current account financing only slightly, to an average of more than 4.0% of GDP by 2007. In this regard, the privatization proceeds from the power utility and telecoms sector are expected to bring higher inflows, but investor attitudes toward the country will change only gradually, despite the reduced political risk and EU candidate status.

Transfers take significant pressure off the balance of payments. Although the contribution of net official transfers to the balance of payments averaged 2.1% in 2002-2004, net private transfers over the same period amounted to an average 19% of GDP due to large remittances from expatriate Macedonian workers.

External liquidity is expected to remain moderate, due to the relatively low level and favorable repayment structure of external debt. In the medium term, gross external financing needs (current account payments plus short-term debt by residual maturity) will remain at about 85% of CARs plus usable foreign exchange reserves.

Narrow external debt

Levels of external debt are moderate. General government external debt fell to an estimated 31% of CARs in 2006, from 45% in 2003. The financial sector is a net external creditor, although this position is declining, and forecast to reach a net external asset position of 10% of CARs by 2010, down from 13% in 2006. The nonfinancial private sector is a moderate debtor, with net external debt about 16% of CARs in the forecast period, but this is sufficiently small not to pose a serious contingent liability to the sovereign. These loans are mostly to private companies taken from major international financial institutions due to the lack of domestic sources in the past.

Ratings Detail (As Of 13-Jun-2007)*

Macedonia (Republic of)		
Sovereign Credit Rating		
Foreign Currency		BB+/Stable/B
Local Currency		BBB-/Stable/A-3
Senior Unsecured		BBB-
Sovereign Credit Ratings History		
23-Aug-2005	*Foreign Currency*	BB+/Stable/B
30-Jul-2004		BB/Positive/B
23-Aug-2005	*Local Currency*	BBB-/Stable/A-3
30-Jul-2004		BB+/Positive/B
Default History		
Foreign currency bank debt 1992-1997		
Population		2.0 million
Per Capita GDP		$3,106

Current Government

Nikola Gruevski (Internal Macedonian Revolutionary Organization-Democratic Party of Macedonian National Unity; VMRO-DPMNE) is prime minister and head of a majority coalition comprising the VMRO-DPMNE, the Democratic Party of Albanians, the New Social Democratic Party, Democratic Renewal of Macedonia, and the Party For A European Future. President Branko Crvenkovski is head of state.

Election Schedule

Parliamentary
Last...... July 2006
Next......July 2010
Presidential
Last......April 2004
Next......April 2009

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact: Sovereign Ratings; SovereignLondon@standardandpoors.com

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