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Macedonia (Republic of)

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Macedonia (Republic of)

Major Rating Factors

Sovereign Credit Rating
Foreign Currency
BB+/Negative/B
Local Currency
BBB-/Negative/A-3

Strengths:

- EU candidate status providing an anchor for reforms and political stability, although this is weakening
- Moderate government debt levels, despite rising deficits
- Moderate, albeit rising external indebtedness.

Weaknesses:

- Persistent structural rigidities reflected in high unemployment, which weigh on economic performance
- Inflexible general government expenditure structure and inefficient social security system that pose a risk to fiscal prudence
- High current account deficit and reduced availability of external financing could eventually put pressure on foreign reserve assets and the exchange rate peg to the euro
- Residual latent, albeit declining, risk of inter-ethnic tensions

Rationale

The ratings on the Republic of Macedonia reflect its deteriorating external liquidity, due to a large increase in the current account deficit from deteriorating terms of trade and reduced external demand, and due to reduced availability of external financing. It also reflects a weakening of the policy anchor that prospective EU and NATO memberships had so far provided for policy prudence, which we expect to lead to increasing structural government deficits.

Increased prices for imported energy, surging imports of capital goods, and a fall in prices and external demand for exported metals will contribute to a rapid deterioration in Macedonia's current account deficit to about 14.9% of GDP in 2008, from 8.0% in 2007. The deficit is expected to improve slightly from 2009. However, in line with recent experiences elsewhere in Central and Eastern Europe, external imbalances and the reduced availability of external financing could eventually lead to a weaker growth performance and mounting pressure on the exchange rate peg to the euro, providing a challenging policy environment.

Macedonia's aspirations to initiate membership negotiations with the EU suffered a setback as a result of irregularities and violence that overshadowed the June 2008 general elections. Consequently, the EU issued a negative assessment in its November 2008 progress report that Macedonia was currently not meeting the EU's political criteria. A further obstacle on the way toward the EU and NATO remains the unresolved issue of Macedonia's constitutional name, to which Greece objects and therefore vetoed Macedonia's accession to Nato in April 2008. A quick resolution of the issue currently appears unlikely.

Budgets surpluses, privatization receipts, early debt repayments, and stable economic growth have supported a continuous decline in the general government debt burden to an expected 24% of GDP in 2008, from 39% in 2005. However, the government recently increased its medium-term deficit targets significantly, aiming for a deficit of up to 4% of GDP by 2011, in order to accommodate Macedonia's large infrastructure investment needs. While we expect this fiscal expansion to lead to only a modest increase in the debt burden to 25% in 2011, there is a risk that rapid fiscal loosening will add to external liquidity pressures, particularly in 2009.

Outlook

A worsening of external liquidity indicators and falling levels of international reserves, potentially driven by an excessively expansionary fiscal policy, could eventually lead to the ratings being lowered. Similarly, further deterioration of EU accession prospects and a lessening in the attendant reform efforts, or a resurgence of ethnic strife could also put pressure on the ratings. Conversely, a return to dynamic and balanced growth after the current slowdown, supported by key structural reforms in social security systems and the energy sector, as well as the sustained pursuit of macroeconomic and external stability and fiscal prudence would contribute positively to Macedonia's creditworthiness.

Table 1

Republic of Macedonia--Selected Indicators

	2003	2004	2005	2006	2007	2008e	2009f	2010f	2011f	Median BB (2008)
GDP per capita ($)	2,284	2,641	2,855	3,123	3,671	3,949	3,993	4,478	5,157	3,567
Real GDP (% change)	2.8	4.1	4.1	4.0	4.7	5.0	3.0	3.5	4.7	5.5
Real GDP per capita (% change)	3.0	3.8	3.9	3.8	4.5	4.8	2.8	3.3	4.4	4.4
General government balance (% of GDP)	(0.0)	0.4	0.2	(0.5)	0.6	0.0	(2.5)	(3.0)	(3.5)	(0.9)
General government debt (% of GDP)	39.4	36.6	39.5	32.9	26.1	23.4	23.3	24.0	25.1	33.8
Net general government debt (% of GDP)	33.4	31.0	30.3	20.9	19.2	17.2	18.1	19.8	21.7	27.1
General government interest expenditures (% of revenues)	3.2	2.6	2.6	3.0	2.4	1.9	1.8	2.0	2.3	11.0
Domestic credit to private sector and NFPEs (% of GDP)	19.0	22.4	25.3	30.3	38.9	42.5	41.7	44.1	47.0	42.2
Consumer price index (average; % change)	1.2	(0.4)	0.5	3.2	2.3	8.5	4.0	3.0	2.5	9.5
Gross external financing needs (% of CARs and usable reserves)	82.7	105.1	97.4	93.3	95.6	101.8	103.5	106.4	107.1	99.2
Current account balance (% of GDP)	(4.0)	(8.4)	(2.7)	(0.9)	(8.0)	(14.9)	(9.3)	(8.9)	(8.7)	(4.1)
Narrow net external debt (% of CARs)	20.2	(1.5)	4.1	(13.2)	(15.4)	(0.9)	4.8	6.5	8.0	21.4

¶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. §The Median data is for 2008. f--Forecast. e--Estimate. NFPEs--Nonfinancial public enterprises. CARs--Current account receipts.

Comparative Analysis

- As for its Balkan peers, the prospect of EU membership remains a key--but potentially weakening--driver of economic reform and political stability in Macedonia.
- Levels of government debt are moderate and below the 'BB' median. Quickly rising fiscal deficits will, however, stop the decline in the debt ratio.
- Current account deficits have been deteriorating rapidly to levels considerably higher than the 'BB' median.

Macedonia's peers include four in the Balkan region: the Republic of Montenegro (BB+/Negative/B; all references to ratings hereafter are to foreign currency sovereign credit ratings); the Republic of Serbia (BB-/Negative/B), EU candidate Republic of Croatia (BBB/Negative/A-3), and EU member Republic of Romania (BB+/Negative/B). Outside the region, EU member Republic of Latvia (BBB-/Watch Neg/A-3), and the Republic of El Salvador (BB+/Negative/B) provide useful comparison.

EU a key policy anchor

As was the case previously for Latvia and Romania, EU candidacy and a perspective to join the EU over the medium term provides an important impetus for reforms and policy prudence in both candidate countries Macedonia and Croatia, as well as for aspirants Montenegro and Serbia. All four are, however, at different stages on their way toward the EU. While Croatia has been a candidate country since 2004 and entered into membership negotiations in mid 2006, Macedonia was awarded EU candidate status in December 2005, but has not yet started membership negotiations. Montenegro concluded a Stabilization and Association Agreement (SAA) with the EU in October 2007--the first important step on the long road toward EU membership--and formally applied for candidacy status in December 2008. Lastly, Serbia is currently in negotiations with the EU to conclude a SAA.

EU membership perspectives for all four sovereigns remain clouded by the uncertainty over the current EU members' willingness to enlarge the EU further. In particular, further EU enlargement remains unlikely as long as the Lisbon treaty, designed to streamline the workings of the EU, hangs in the balance. Apart from that external constraint, however, Macedonia's peers continue to make progress toward eventual EU membership, notably Serbia under a new, EU-friendly government. By contrast, Macedonia's membership aspirations have been suffering notable setbacks in 2008. In April 2008, the Hellenic Republic (Greece; A/Stable/A-1) blocked Macedonia's accession to NATO on account of the still unresolved dispute between the two countries over Macedonia's constitutional name. As long as the name issue remains unresolved--for which there is currently no clear perspective--there is also no perspective for Macedonia to join the EU, as Greece will have to give its consent, too. Furthermore, in its November 2008 progress report, the European Commission (EC) concluded that Macedonia was not yet meeting the EU's political criteria for membership.

A weakening policy anchor carries downside risks

Certain risks arise once the strong policy anchor of EU membership wears off, be it after EU accession, or as a result of a diluted perspective for future accession, as is currently the case for Macedonia. Many new EU members, with Latvia and Romania illustrative examples, experienced periods of populist policies, less cohesive coalition governments, and a weakened consensus for prudent policies, once the overarching policy anchor and unifying goal of EU membership had fallen away, and governments had to formulate their own policy agendas and priorities, instead. While Macedonia's EU membership perspective remains broadly intact despite recent setbacks and uncertainty regarding timing, certain recent shifts in policy, including the decision to run significantly higher fiscal deficits in the coming years, could be indicators of a similar reorientation and increased assertiveness as a result of the diluted EU accession perspective.

Income among the lowest in peer group

Income levels in Macedonia are lower than European peers, in particular lagging behind Croatia, Latvia, and Romania. Macedonia's per capita income levels, at $3,950 in 2008, 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 performance, averaging 4.6% over 2006-2008, has only slowly been catching up with those of its peers and the 'BB' median (see chart 2). In 2009, as for most of its peers, Macedonia's growth is set to slow markedly as a result of the global economic slowdown and the reduced availability of external financing for Macedonia's large current account deficit. Not having experienced a consumption and credit boom over the past years, however, the growth slowdown will not be as pronounced as in Latvia and Romania.

Chart 1

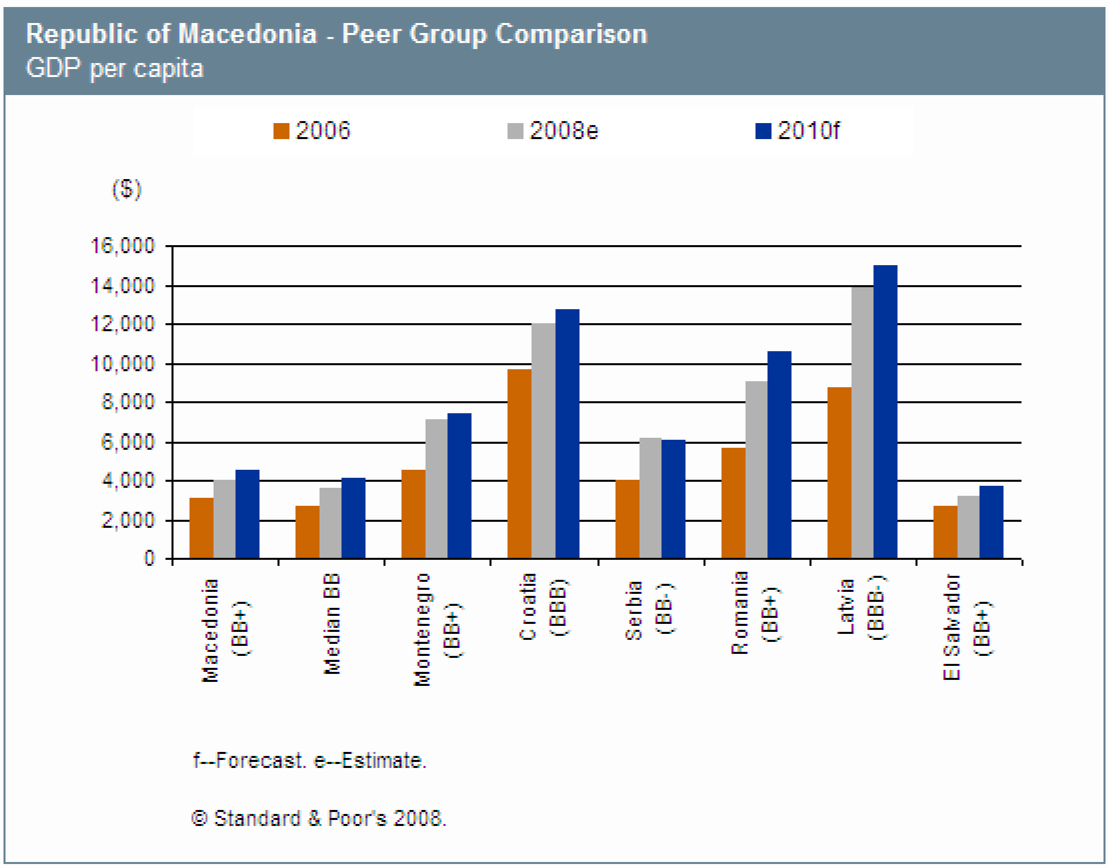
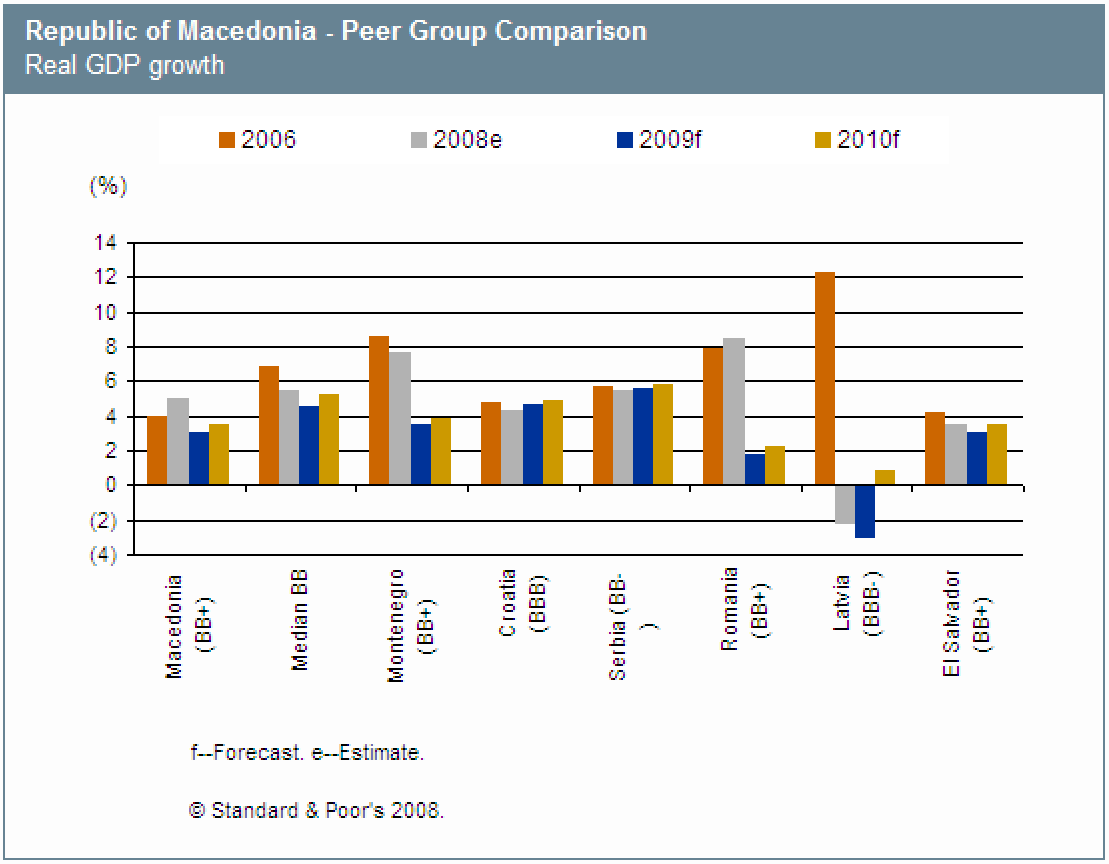


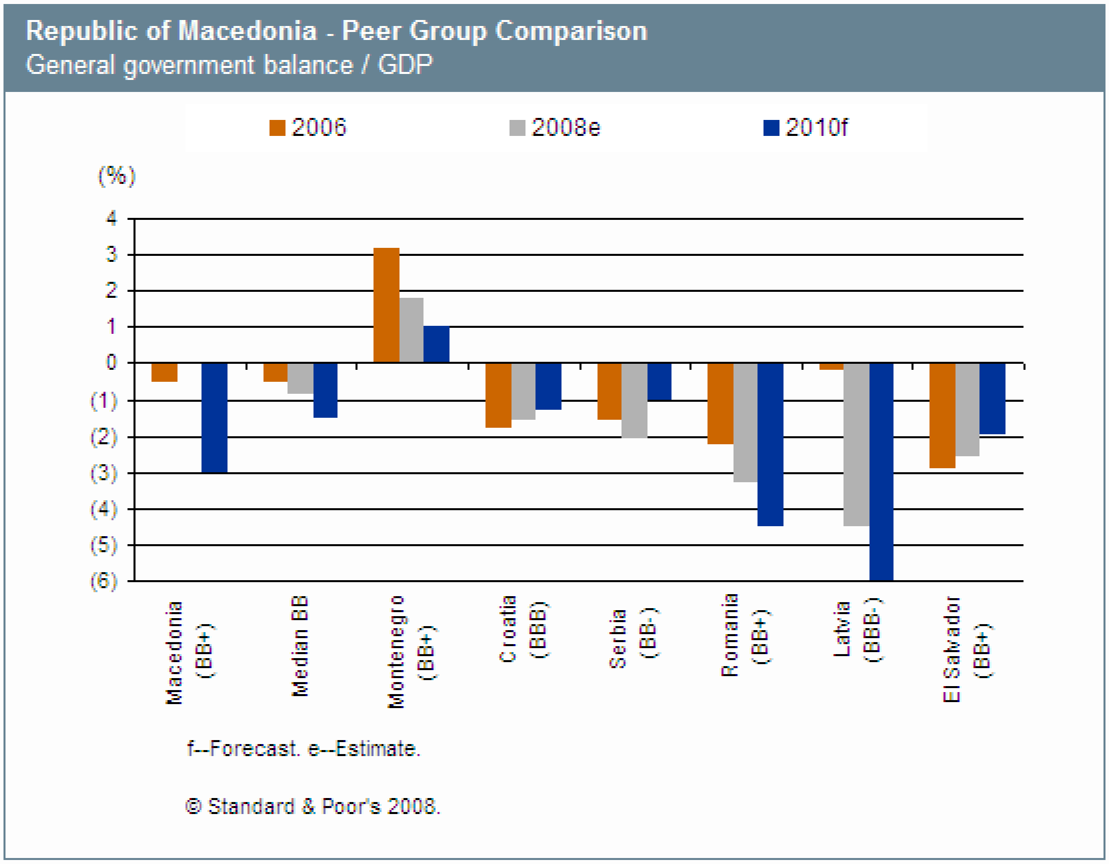
Chart 2



Rising deficits but moderate debt burden

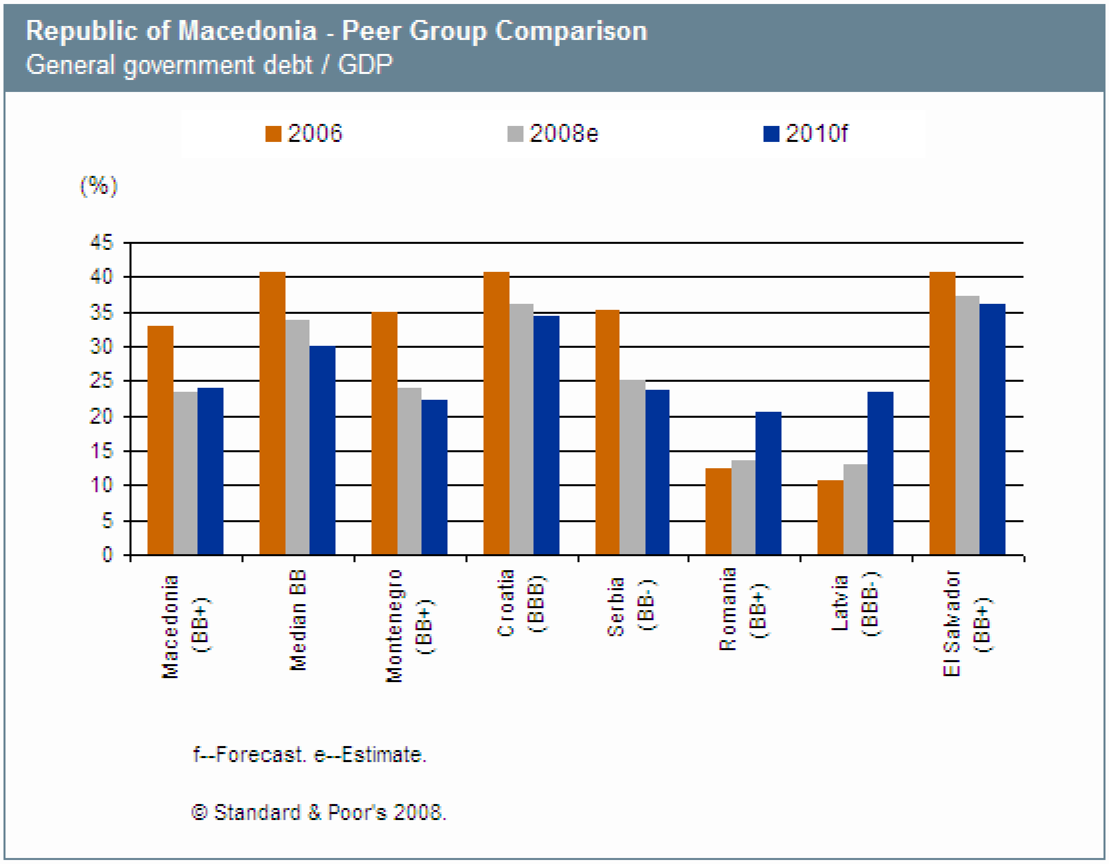
Macedonian authorities have run comparatively tight fiscal policies, at an average surplus of 0.1% of GDP 2004-2008. The government intends to increase deficits going forward, however, to up to 4% of GDP by 2011, because it aims to cut contributions and increase investment spending (see chart 3). By comparison, fiscal results are better in Montenegro, thanks to more ambitious consolidation as well as buoyant revenues on the back of a booming economy. By contrast, deficits in Romania and Latvia continue to deteriorate rapidly as a result of expansionary fiscal policies, and as their economic booms come to an end. Deficits are forecast to peak at 6.0% of GDP in Latvia in 2010 and at 4.5% in Romania.

Chart 3



As a result of relatively low financing requirements, debt repayments, and financial support through external grants and subsidized loans, general government debt in Macedonia is moderate and has been falling to 23% of GDP in 2008, well below the 'BB' median of 34% of GDP, and higher only than in Romania and Latvia. While debt levels continue to trend down for many of Macedonia's peers, with the notable exceptions of Latvia and Romania, the downward trend will come to a halt in Macedonia as a result of the increased deficits (see chart 4).

Chart 4

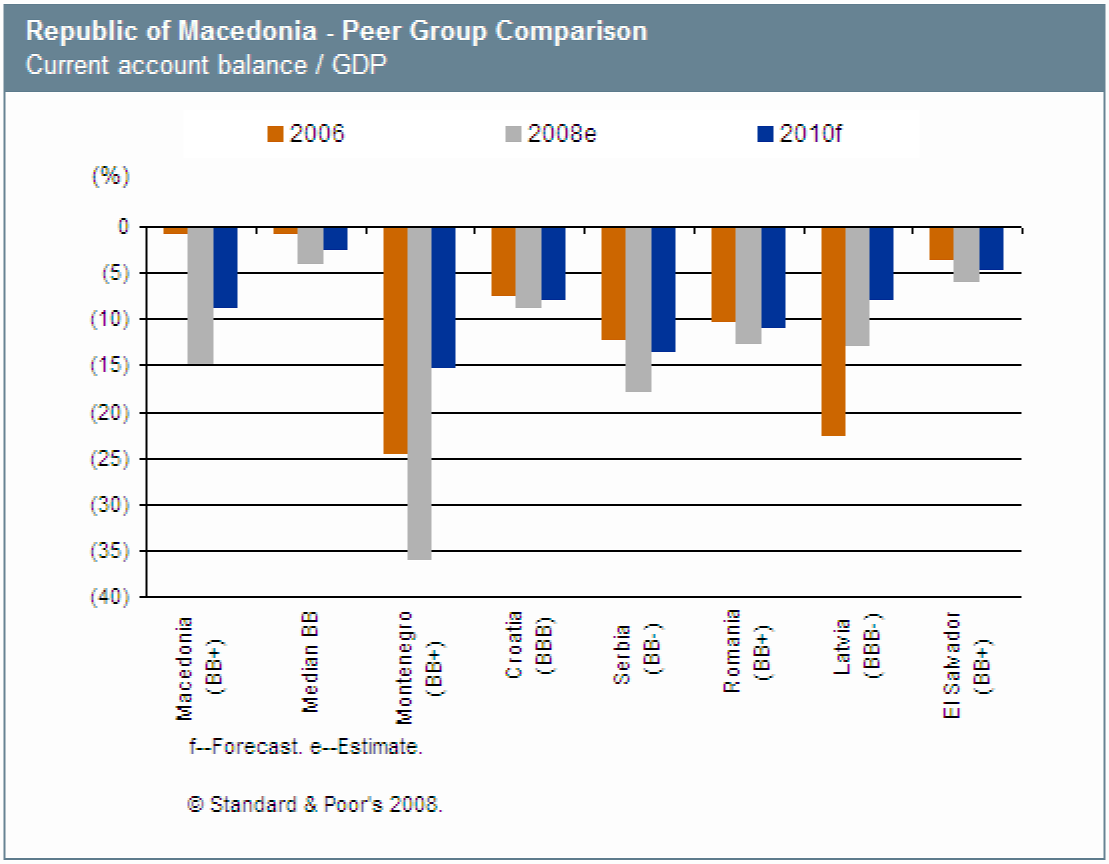


Quickly deteriorating current account deficit

Like regional peers that are catching up with the EU in terms of economic development and structure, Macedonia has a sizable trade deficit, at 28% of GDP in 2008, reflecting high capital goods import requirements. This is analogous with peers, particularly Croatia (25% of GDP), Serbia (26%), and Montenegro (54%). 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). Extremely strong levels of foreign direct investment (FDI) in Montenegro, mainly stemming from thriving investment in real estate and tourism sectors, cover about one-half of the gargantuan current account deficits.

While current account deficits remained broadly unchanged (or even declined in the case of Latvia) for Macedonia's peers, it has been deteriorating quickly in Macedonia in 2008, to a large degree the result of soaring energy prices as well as weakening external demand (see chart 5). Since the deficits of Macedonia and its peers have invariably been financed partly through net external borrowing, the changed international financial environment and reduced availability of external financing bring about considerable adjustment requirements to reduce external imbalances.

Chart 5



Political Environment: Strength of EU Anchor Weakening

- Early elections left the government with a strong double-majority.
- Prospects of EU membership remain a driver of reform, but numerous setbacks on the way, including the unresolved name issue, have weakened the strength of this policy anchor.
- Inter-ethnic relations have normalized, as demonstrated by the restricted impact of Kosovo's independence, but will remain a potential but non-acute risk for now.

Early elections in June 2008 led to the re-election of a multi-party block dominated by the Internal Macedonian Revolutionary Organization-Democratic Party of Macedonian National Unity (VMRO-DPMNE), which gained an absolute majority of seats in parliament. Despite the absolute majority, VMRO-DPMNE entered into a coalition with the largest Albanian party, Democratic Union for Integration (DUI), which secures the government the double-majority (of both total members of parliament--MPs--and of ethnic minority MPs) required for passing legislation affecting ethnic minorities.

The elections were accompanied by violence and irregularities in several ethnic Albanian districts, and a rerun of the vote was required in some. The OSCE judged the elections to have been considerably worse than the previous general elections in 2006. Consequently, Macedonia's EU accession efforts have suffered a blow, as the European

Commission (EC) had repeatedly stated that fair elections would be a key element on the way to initiating EU accession talks. In its November 2008 progress report, therefore, the EC judged that Macedonia was currently not yet meeting the political criteria for EU accession.

The long-standing dispute with Greece over Macedonia's constitutional name has now become a key roadblock on the way toward further European and international integration. In April 2008, Greece refused to endorse the proposed invitation for Macedonia to join NATO because of the name issue, while invitations were extended to Albania and Croatia. Similarly, it is unlikely that Greece would assent to Macedonia joining the EU without prior resolution of the name issue. Greece is currently unlikely to concede on the name dispute, while Macedonia has now filed a case against Greece with the International Court of Justice over Greece not honoring an interim agreement on the name issue between the two countries. A quick resolution of the issue currently appears unlikely, which could eventually strengthen nationalists in Macedonia.

The government still remains broadly focused on the requirements of EU membership, as demonstrated by the ongoing reform drive and efforts to further vitalize the economy and the labor market. The unclear perspective for resolving the obstacles toward EU accession, discussed above, has weakened the strength of prospective EU membership as a policy anchor, however. This is evident from a number of policy decisions that are not in line with future EU accession, which, however, the government considers to be in Macedonia's best interest. These include the government's recent announcement of increasing budget deficits, as well as the creation of free economic zones to attract foreign direct investment. Furthermore, Macedonia's EU accession prospects also remain clouded by uncertainty surrounding the EU's adoption of the Lisbon Treaty, without which further EU enlargement appears unlikely over the medium-term.

The implementation of the Ohrid Framework Agreement (OFA) has markedly improved minority rights and allowed for increased ethnic Albanian representation in public administration, particularly by strengthening the power of local governments. The OFA has broad political support among Macedonian citizens, and there is a general perception that both ethnic groups have ultimately benefited from it. Despite the absence of notable inter-ethnic tensions, however, inter-ethnic relations will continue to play an important role in Macedonian politics.

Renewed ethnic conflict that could undermine political stability is unlikely. A sign of political stability in Macedonia can be seen in Kosovo's declaration of independence in February 2008, and Macedonia's recognition of Kosovo as an independent state in October 2008, both of which did not lead to notable repercussions in Macedonia. Instead, inter-ethnic relations in Macedonia could face increased strain should Macedonia's progress in economic development and international political integration significantly lag that of its neighboring peers.

Economic Prospects: Ongoing Reforms, But Economic Correction Under Way

- Unemployment, one key obstacle to accelerated dynamism of the Macedonian economy, remains high, but the government continues to implement key reforms to address the underlying causes.
- Macedonia has managed to secure increasing levels of FDI to further diversify and upgrade its economy. Inflows will fall over the next two years, however.
- Increasing levels of investment helped economic growth to accelerate from modest levels, but the deteriorating international environment is expected to lead to a slowdown in 2009 and 2010.

Table 2

Republic of Macedonia - Economic & Financial Indicators

	2003	2004	2005	2006	2007	2008e	2009f	2010f	2011f
Nominal GDP (bil. MKD)	251.5	265.3	286.6	310.9	335.8	375.5	412.6	445.6	484.1
Nominal GDP (bil. $)	4.6	5.4	5.8	6.4	7.5	8.1	8.2	9.2	10.6
GDP per capita ($)	2,284	2,641	2,855	3,123	3,671	3,949	3,993	4,478	5,157
Real GDP (% change)	2.8	4.1	4.1	4.0	4.7	5.0	3.0	3.5	4.7
Real GDP per capita (% change)	3.0	3.8	3.9	3.8	4.5	4.8	2.8	3.3	4.4
Real domestic demand (% change)	0.1	7.5	1.2	5.1	5.2	11.2	(0.4)	3.0	4.1
Real investment (% change)	1.1	10.9	(5.4)	10.0	15.3	20.0	4.0	6.0	8.0
Gross domestic investment (% of GDP)	20.0	21.9	20.8	21.9	23.2	26.8	26.3	27.1	28.0
Gross domestic savings (% of GDP)	16.0	13.4	18.1	21.0	15.2	11.9	17.0	18.1	19.3
Real exports (% change)	(5.7)	13.0	15.5	9.4	17.2	12.5	3.0	8.0	10.5
Unemployment rate (average claimant count; %)	36.7	37.2	37.3	36.0	34.9	33.0	31.0	29.0	27.0
Real GDP per Employee growth (%)	5.9	8.5	(0.2)	(0.6)	1.2	1.0	(0.0)	0.5	1.6
Consumer price index (% change)	1.2	(0.4)	0.5	3.2	2.3	8.5	4.0	3.0	2.5
Domestic credit to private sector and NFPEs (% change)	8.5	24.5	22.2	29.9	38.8	22.0	8.0	14.0	16.0
Domestic credit to private sector and NFPEs (% of GDP)	19.0	22.4	25.3	30.3	38.9	42.5	41.7	44.1	47.0

MKD--Macedonian denar. f--Forecast. e--Estimate.

Economic structure

Macedonia is a small and moderately diversified economy with steel and textiles manufacturing as its leading sectors (accounting for a combined 57% of goods exports in 2007). GDP per capita is estimated at $3,920 in 2008. Reported national income statistics on Macedonia, however, should be treated with caution.

Unemployment in Macedonia is high, at an estimated 35% in 2007, in spite of more than 4% employment growth over 2005-2007. Unemployment can partly be explained by the large size of the gray economy in combination with generous benefit systems. Other factors contributing to high unemployment are the rigid structure of the labor market, a large tax wedge on labor, inefficient institutions and a weak business climate. The government is addressing these issues through numerous reforms to improve the business environment and reduce regulatory requirements. Following the introduction of a flat rate for personal income tax (PIT) in 2007, for 2009 the government aims to harmonize and rationalize systems of social security, while at the same time bringing down contributions to 22% from 32% over three years. These reforms could significantly support Macedonia's medium-term growth prospects if they succeeded in better tapping the large pool of unemployed persons.

Macedonia has managed to attract increasing levels of foreign direct investment (FDI), albeit from a low base. Net FDI inflows over 2006-2008 are expected to average 6% of GDP annually, flowing into areas such as the metals and power sectors, financial intermediation, and food and food processing. Investment inflows should support further diversification and structural upgrading of Macedonia's economy, and reduce the strong dependence on the metals and textile sectors, which are facing competitive pressures and structural challenges. In the same vein, the energy sector would also benefit from further foreign investment and an adjustment in prices to better reflect costs, given that almost one-third of electricity is imported. Net inflows in 2009-2010 will be considerably lower, however, as a result of the deteriorated international economic environment.

Economic growth

Growth has been modest compared with peers, at an average 4.1% over 2004-2006, held back by structural rigidities, low levels of investment, and only gradually receding political risk. Growth started to accelerate in 2007, peaking at 6.5% in the second quarter of 2008, on the back of accelerating investment growth, helped by the continuous progress in reforms over the past years.

The deteriorated international economic environment is driving a slowdown in economic growth, to an expected 3% in 2009 and 3.5% in 2010, from 5.0% in 2008. A deterioration in Macedonia's terms of trade and a reduction in external demand have started to pressure Macedonia's current account, while the reduced availability of external international financing will require a correction in domestic demand in order to contain the reduction in external reserve assets. Fiscal expansion, as foreseen in the government's medium-term planning, could deliver impulses to economic growth in 2009 and 2010, but again risks putting further pressure on international reserves, unless offsetting external financing is secured, or offsetting reductions in private sector domestic demand occur.

Fiscal Flexibility: Fiscal Expansion Ahead

- After a balanced budget in 2008, deficits are expected to increase rapidly to 3.5% of GDP in 2011, as the government aims to increase spending.
- General government debt continues to fall to 23% of GDP in 2008, but will rise again gradually from there.

Table 3

Republic of Macedonia - Fiscal Indicators

(% of GDP)	2003	2004	2005	2006	2007	2008e	2009f	2010f	2011f
General government revenues	34.5	33.6	35.2	33.5	35.6	37.5	37.0	36.0	35.0
Of which central government	34.5	33.6	35.3	33.7	35.0	37.5	37.0	36.0	35.0
General government expenditures	34.5	33.2	35.0	34.0	35.0	37.5	39.5	39.0	38.5
Of which central government	34.5	33.2	35.0	34.0	35.0	37.5	39.5	39.0	38.5
General government balance	(0.0)	0.4	0.2	(0.5)	0.6	0.0	(2.5)	(3.0)	(3.5)
Of which central government	(0.0)	0.4	0.3	(0.4)	0.0	0.0	(2.5)	(3.0)	(3.5)
General government primary balance	1.0	1.3	1.1	0.5	1.5	0.7	(1.8)	(2.3)	(2.7)
Central government primary balance	1.0	1.3	1.2	0.7	0.9	0.7	(1.8)	(2.3)	(2.7)
General government balance (% of revenues)	(0.1)	1.2	0.7	(1.6)	1.8	0.0	(6.8)	(8.3)	(10.0)
General government interest payments (% of revenues)	3.2	2.6	2.6	3.0	2.4	1.9	1.8	2.0	2.3
Central government interest payments (% of revenues)	3.2	2.6	2.6	3.0	2.5	1.9	1.8	2.0	2.3
General government debt	39.4	36.6	39.5	32.9	26.1	23.4	23.3	24.0	25.1
Of which central government debt	39.4	36.6	39.5	32.9	26.1	23.4	23.3	24.0	25.1
General government net debt	33.4	31.0	30.3	20.9	19.2	17.2	18.1	19.8	21.7
Of which central government net debt	33.4	31.0	30.3	20.9	19.2	17.2	18.1	19.8	21.7

f--Forecast. e--Estimate.

Revenue, expenditure, and balance performance

The general government recorded a surplus of 0.6% of GDP in 2007. This well exceeded the 1% of GDP deficit target, despite supplementary budgets that increased expenditure by 5%, and despite the fact that for the first time planned capital spending was virtually fully executed. Budgetary overperformance was driven by buoyant tax revenues, which exceeded the initial budget by 11%, despite the introduction of a 12% flat tax rate for personal and corporate income taxes (PIT and CIT). Strong tax performance continued in 2008, despite 2pp cuts in PIT and CIT rates, and we expect a broadly balanced budget (against a deficit target of 1.5% of GDP). As in the previous year, the government passed supplementary budgets to use excess revenues for a 12% expenditure increase for popular measures, such as pension increases or agricultural subsidies. These expansionary expenditure increases slow down efforts to increase the low expenditure flexibility of Macedonia's budget, with more than 70% of general government expenditure in 2007 consisting of wages and transfers.

The government significantly revised its medium-term fiscal plan in 2008. While in the past deficit targets had been relatively modest, in line with International Monetary Fund (IMF) advice, the government has now decided to significantly increase deficit targets to accommodate Macedonia's large infrastructure investment needs in such areas as road, rail, and energy infrastructure. Therefore, the government intends to quickly increase deficits to 4% of GDP by 2011. In the current international economic environment with limited access to external financing, however, such fiscal expansion risks either leading to an additional drain on Macedonia's modest external reserves, or to crowding out of private sector investment, unless the government can manage to secure additional external financing for its investments. EU pre-accession funds could be one such source, but will not nearly suffice.

The government continues to reform the country's inefficient and costly systems of social security. For 2009, it plans to harmonize and streamline the financing side of the system, while at the same time significantly lowering combined contributions to 22% from 32% over three years.

Government debt and interest burden

Broadly balanced budgets and debt buybacks have reduced general government debt to an estimated 23% of GDP in 2008, from 39% of GDP in 2005. While one-third of that is domestic debt, more than 90% of the debt is denominated in foreign currencies, predominantly euros, as most of the so-called structural bonds issued by the government were foreign currency denominated. The government issued its first and so far only international bond of €150 million in 2005, maturing in 2015. The bond is rated 'BBB-' due to the recovery rating of '2' assigned to Macedonia's long-term foreign currency debt, indicating recovery prospects in the range of 80%-100%. The average time to maturity of Macedonia's debt continues to decline, to 6.5 years at the end of June 2008, from 7.4 years at the end of 2005, mainly reflecting the declining share of concessionary lending.

From 2009, we expect the changed path of fiscal policy, as well as the slowdown in economic growth, to lead to a gradual increase in debt ratios, reaching about 25% of GDP in 2010.

General government interest expenditure relative to revenues remains low, at 2.4% in 2007, reflecting the still predominantly concessional terms on much of the government debt, mainly owed to bilateral and multilateral lenders.

Off-budget and contingent liabilities

The level of central government guarantees remains low, at about 2.6% of GDP in 2007. The external debt of public enterprises totaled 2.8% of GDP in 2007 (mainly owed by the railways and the power utilities), 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, which has so far not been directly affected by the international financial turmoil and relies predominantly on domestic deposits to fund lending, poses a modest contingent liability to the government.

Monetary Policy: High Inflation Abating

- Inflation surged to more than 10% over the course of 2008 on rising food and energy prices, but will fall rapidly again going forward.
- The denar is pegged to the euro. Large external imbalances, if unaddressed, risk putting pressure on international reserves and eventually undermining the credibility of the peg.

The fixed exchange rate of the Macedonian denar to the euro (previously the German mark) has been a successful nominal anchor since 1995. After averaging just 1.4% over 2002-2007, a number of largely external shocks, predominantly in food prices (which account for about 40% of the consumer price basket) and energy rapidly pushed up inflation to exceed 10% in 2008, with average inflation expected at 8.5% in 2008. Inflation will fall again rapidly in 2009, however, as the price shocks abate and the economy slows.

Large inflows of foreign exchange through 2007 resulted in increased supply of denars and falling domestic interest rates, despite efforts by the National Bank of the Republic of Macedonia (NBRM) to sterilize inflows. Increased competition in the banking sector led to an acceleration in credit growth, which reached 39% in 2007 (albeit from a comparatively low base, with domestic credit reaching 39% of GDP in 2007). The NBRM responded in 2008 by increasing rates on central bank bills, increasing capital requirements, and applying tighter controls on growth of credit to households through administrative measures.

The banking sector is almost fully privatized, and 14 out of 18 banks are now majority foreign owned. The system is dominated by three large banks, which account for 70% of credit. Only 45% of system lending is in denar, while 32% are foreign currency linked and 23% are in foreign currency proper. The system's loan-to-deposit ratio remains at about 85%, and consequently lending growth is predominantly funded from deposits, which continue to grow at about 20%. About 56% of deposits are in foreign currency.

Foreign exchange reserves have been growing in nominal terms (to €1.5 billion in 2007 from €716 million in 2004), but usable reserves in months of current account payments have only increased moderately over the same period (to 3.1 months from 2.9). With Macedonia's current account deficits up significantly from 2008 and availability of external financing reduced at the same time, there is a risk that external imbalances will put increasing pressure on reserve levels, which could in turn eventually weaken the credibility of the exchange rate peg. We would expect the NBRM to not watch such a decline in reserves without taking countervailing measures, however.

External Finances: Deteriorating Current Account Deficit

- The current account deficit is expected to deteriorate significantly to about 15% of GDP in 2008.
- External financing needs remain below those of peers, but will increase.
- As measured by narrow net external debt, Macedonia is quickly moving from a net external lender to a net external borrower position.

Table 4

Republic of Macedonia - External Indicators

	2003	2004	2005	2006	2007	2008e	2009f	2010f
(% of GDP)								
Current account balance	(4.0)	(8.4)	(2.7)	(0.9)	(8.0)	(14.9)	(9.3)	(8.9)
Trade balance	(18.4)	(21.2)	(18.3)	(20.2)	(21.7)	(28.1)	(24.1)	(23.7)
Net foreign direct investment	2.5	6.0	1.6	6.7	9.3	8.0	3.5	5.0
(% of CARs)								
Current account balance	(6.8)	(14.0)	(4.1)	(1.2)	(9.8)	(17.2)	(10.7)	(9.7)
Net external liabilities	73.7	57.3	49.7	39.1	34.0	50.8	60.1	60.5
Total external debt	80.1	55.1	57.8	47.4	37.1	42.4	41.4	37.3
General government external debt	0.5	0.3	0.3	0.2	0.1	0.1	0.1	0.1
Narrow net external debt*	20.2	(1.5)	4.1	(13.2)	(15.4)	(0.9)	4.8	6.5
Net public sector external debt	14.4	2.2	(0.1)	(17.1)	(22.1)	(16.0)	(9.7)	(7.0)
Net nonbank private sector external debt	18.0	10.2	10.8	7.5	4.8	10.3	8.7	8.3
Net banking sector external debt	(19.5)	(22.2)	(14.3)	(13.4)	(9.2)	(5.7)	(3.8)	(2.4)
Net investment payments	2.3	1.2	2.9	0.8	6.3	2.5	1.4	1.5
Net interest payments	1.2	0.8	0.7	0.5	0.4	0.2	0.7	0.7
Reserves/CAPs (months)	3.3	2.9	2.7	3.2	3.1	3.1	3.0	2.1
Gross external financing needs (% of CARs and usable reserves)	82.7	105.1	97.4	93.3	95.6	101.8	103.5	106.4

*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. e--Estimate. CARs--Current account receipts. CAPs--Current account payments.

External liquidity

The current account deficit has been widening rapidly over the course of 2008, to an expected 14.9% of GDP. The deterioration was driven firstly by a rising trade deficit on the back of deteriorating terms of trade (higher energy prices and falling metals prices), reduced export demand, and higher imports of capital goods, and secondly by falling private transfers. This compares to a deficit of 8.0% of GDP in 2007 (recently revised significantly upward from 3.2% to reflect higher retained profits).

We expect the current account deficit to decline in 2009 because energy prices should remain well below their 2008 averages and domestic demand growth should slow down. It will, however, remain high, at a forecast 9.4% of GDP, because export demand as well as metals prices remain weak and imports are stimulated by fiscal expansion. As the availability of external financing remains greatly reduced in 2009, and with net FDI expected to be much less than the average 8% of GDP during 2006-2008, we expect international reserves to decline in 2009 as a consequence.

External liquidity is expected to deteriorate as a result, but should still remain better than that of Macedonia's peers, due to the relatively low level and favorable repayment structure of external debt. Gross external financing needs (current account payments plus short-term debt by residual maturity) will decline to 104% of current account receipts (CARs) plus usable foreign exchange reserves in 2009, from 96% in 2007.

Narrow external debt

Levels of external debt are moderate. The public sector has moved into a solid net external lender position as measured by net public sector external debt, thanks to privatization proceeds and early repayment of debt. Similarly, the financial sector is also a net external lender, thanks to the excess liquidity in the financial system.

As measured by narrow net external debt (private and public sector nonequity external obligations minus reserves, public sector liquid external assets, and financial institutions' external assets), we expect Macedonia to quickly move from a net external lender position of 15% of CARs in 2007 to a net external borrower position of 5% in 2009.

Ratings Detail (As Of December 19, 2008)*		
Macedonia (Republic of)		
Sovereign Credit Rating		
Foreign Currency		BB+/Negative/B
Local Currency		BBB-/Negative/A-3
Senior Unsecured (8 Issues)		BBB-
Sovereign Credit Ratings History		
01-Dec-2008	*Foreign Currency*	BB+/Negative/B
23-Aug-2005		BB+/Stable/B
30-Jul-2004		BB/Positive/B
01-Dec-2008	*Local Currency*	BBB-/Negative/A-3
23-Aug-2005		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		$3,950
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 and the Democratic Union for Integration. President Branko Crvenkovski is head of state.		
Election Schedule		
Parliamentary Last.......June 2008 Next...... June 2012 Presidential Last.......April 2004 Next.......March 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.

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