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Research Update:

Republic of Macedonia 'BB-/B' Ratings Affirmed; Outlook Stable

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Overview

- Macedonia has low income levels and high external liquidity requirements, offset by still-moderate, albeit rising, external and public debt burdens.
- We are therefore affirming our 'BB-/B' sovereign credit ratings on Macedonia.
- The stable outlook balances the risks from rising public and external indebtedness against Macedonia's economic prospects, which benefit from recurrent investment inflows.

Rating Action

On Oct. 16, 2015, Standard & Poor's Ratings Services affirmed its 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on the Republic of Macedonia. The outlook is stable.

Rationale

The ratings on Macedonia reflect our view of its relatively low income and wealth levels (we anticipate per capita GDP will amount to $4,500 in 2015), weak checks and balances between political institutions, and limited monetary policy flexibility arising from the country's fixed exchange rate regime. The ratings are supported by moderate--albeit rising--external and public debt levels.

Since 2010, export activity, alongside expansionary fiscal policy, has supported the economy and helped trim unemployment, which remains very high, however, at 26.8% as of June 30, 2015. The central bank's accommodative monetary policy, increased bank lending and, more recently, low inflation, have supported private consumption growth, although the strength of the underlying recovery, independent of loose monetary and fiscal conditions, is more doubtful. We expect that over the next four years, growth will be supported by ongoing public projects, foreign direct investment flows into Macedonia, as well as continued net export growth. We have, however, lowered our 2015-2018 average growth forecast to just below 3% (from 3.4%) to reflect a tighter fiscal stance, which we believe the authorities would have to adopt to be compliant with their fiscal rule. The rule, due to come into effect in 2017, would limit the general government deficit to 3% of GDP and public sector debt to 60% of GDP.

The Macedonian government has struggled with fiscal discipline over the past five years, and 2015 is the fifth successive year in which the general government deficit is set to exceed its initial target. Fiscal consolidation is likely to be slower than envisaged by the proposed fiscal rule. We forecast the general government deficit will amount to 4% of GDP in 2015 before narrowing to 3.2% in 2018. The difference between our expectation and that of the Macedonian authorities arises

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from our lower expectation for real GDP growth, as well as the government's recent track record of missing its fiscal targets. It has not met targets both due to budgeted revenue projections and government expenditure overruns. The electoral calendar will also likely influence fiscal outcomes. Under an EU and U.S.-brokered deal that ended Macedonia’s political crisis (centered on mass illegal surveillance), early elections will be held in April 2016, following a three-month period under an interim bipartisan government after the current coalition steps down.

We expect general government debt will more than double to 43% of GDP in 2015, from 20% in 2008, while the stock of guarantees to public-sector enterprises will likely quadruple to an estimated 8% of GDP over the same time period because the government has increased off-balance-sheet financing. Despite the early repayment of its outstanding debt to the International Monetary Fund earlier this year, Macedonia's general government debt will continue to rise through to 2018 because deficits will likely remain debt financed. We anticipate gross general government debt will rise to 47% of GDP in 2018, while the stock of guaranteed debt is set to increase toward 10% of GDP as public entities such as the Public Enterprise for State Roads draw on loans for infrastructure spending. This will bring the stock of public sector debt (excluding nonguaranteed debt of state-owned public enterprises) to 57% of GDP and very close to the 60% of GDP threshold under the proposed fiscal rule.

Seventy-five percent of government debt is denominated in foreign currency, which increases the vulnerability of the government's balance sheet to any potential foreign-exchange movements. We expect that this ratio could rise further, based on our understanding that the debt management office's strategy envisages a greater proportion of financing through external debt issuance. Furthermore, we think the share of commercial government debt held by nonresidents will rise from just under 50% currently. The banking system holds, on average, about 12% of its assets in government securities and central bank bills. As such, we think the system would struggle to materially increase its creditor share of the domestic government bond market.

With the public sector borrowing increasingly abroad, Macedonia's external indebtedness has been on a rising trajectory. We estimate gross external debt will rise to more than 95% of 2015 current account receipts (CARs), an increase of 20 percentage points since 2011. We anticipate external borrowing, and to a lesser extent foreign investment flows, will continue to finance the current account deficit. The latter will widen over 2015-2018 as investment-related imports pick up.

We consider the checks and balances between Macedonia's institutions to be weak. In its 2014 progress report on Macedonia, the EU highlighted deteriorating media freedom and problems related to the independence of the judiciary. In our opinion, fiscal slippages and the weakening quality of public finances since the 2008-2009 global financial crisis also point to a loose framework for vetting the cost of public procurement, as well as current public expenditure.

Macedonia has been an EU candidate since 2005, but a dispute with Greece over its constitutional name continues to hamper progress in its accession talks. Although negotiations are underway to reach a resolution, our forecast through 2018 does not incorporate the benefits of accession.

The Macedonian denar is pegged to the euro. At an estimated $2.4 billion, Macedonia's foreign reserves cover the monetary base about 2x, implying strong backing for the pegged currency regime. At the same time, net reserves (excluding the foreign currency needed to convert the monetary base into euros) cover external short-term debt by remaining maturity 0.6x, which is lower than for many peers and suggests that external vulnerabilities inherent to a fixed exchange-rate regime remain. The exchange rate regime restricts monetary policy flexibility. However, central bank measures have succeeded in lowering overall euro-ization in Macedonia, bringing foreign currency-denominated deposits and claims below 50% of total deposits and claims.

Since 2012, the central bank has eased monetary policy, with three cuts to its key interest rate as well as to reserve requirements, to incentivize lending. It has also stipulated lower reserve requirements for denar-denominated liabilities, compared with those denominated in foreign currency, to engineer more lending and deposit-taking activity in the domestic currency. This effort has successfully reduced the share of foreign currency-denominated and indexed loans and deposits to below 50%. Rather exceptionally for the region, bank lending in Macedonia--including to corporations--has continued to grow briskly, increasing by about 9% in 2015.

Although the banking system seems well capitalized, profitable, and funded by domestic deposits, the two largest subsidiaries operating in Macedonia have Greek and Slovenian parents--the National Bank of Greece S.A. and Nova Ljubljanska Banka. If either one or both parent banks were to come under pressure to cut exposure to or sell their subsidiaries in noncore markets, we could see a liquidity squeeze for their Macedonian subsidiaries and associated external outflows. It appears, however, that the Macedonian regulatory and supervisory framework has appropriate policies in place to address liquidity risks associated with potential withdrawals by parent banks. In addition, the central bank this year imposed temporary capital flow measures aimed at preventing corporate entities from borrowing domestically only to lend on to Greek entities.

Outlook

The stable outlook balances the risks we see from rising public and external indebtedness against Macedonia's economic prospects, benefiting from recurrent investment inflows over the next four years.

We could raise our ratings on Macedonia if reforms directed toward higher and broader-based growth were matched with improved effectiveness and accountability of public institutions.

We could lower our ratings if large fiscal slippages were to challenge public debt sustainability, raise sovereign borrowing costs, and substantially increase external obligations, given the constraints of the exchange-rate regime. We could also lower the ratings if we saw off-budget activities increasing significantly and an increasing probability of contingent liabilities on the government's balance sheet. In addition, if parents of systemically important banks operating in Macedonia were to cut exposure to their subsidiaries, heightening pressure on both banking sector liquidity and external finances, we could consider a negative rating action.

Key Statistics

Table 1

Republic of Macedonia Selected Indicators

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. MKD)	411	434	460	459	473	498	520	544	571	597
Nominal GDP (bil. $)	9	9	10	10	10	11	9	9	10	10
GDP per capita ($ 000s)	4.5	4.5	5.1	4.6	4.9	5.2	4.5	4.5	4.8	5.0
Real GDP growth	(0.9)	2.9	2.8	(0.4)	2.9	3.8	3.0	3.0	2.8	2.6
Real GDP per capita growth	(1.1)	2.7	2.5	(0.5)	2.8	3.6	2.8	2.8	2.6	2.4
Real investment growth	(0.4)	(6.7)	9.6	20.0	(12.1)	13.4	6.5	3.0	3.0	3.0
Investment/GDP	26.2	24.9	26.2	29.4	24.3	26.0	26.8	27.0	27.2	27.4
Savings/GDP	19.7	22.8	23.7	26.3	22.3	24.5	23.5	23.6	23.3	23.2
Exports/GDP	39.2	46.6	54.9	53.6	53.9	58.9	59.9	61.5	63.4	65.5
Real exports growth	(15.8)	23.6	10.5	0	4.5	17.0	5.6	6.5	6.5	6.5
Unemployment rate	32.2	32.0	31.4	31.0	29.0	28.0	27.5	27.3	27.0	26.7
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(6.5)	(2.1)	(2.5)	(3.1)	(1.9)	(1.5)	(3.3)	(3.4)	(3.9)	(4.2)
Current account balance/CARs	(12.6)	(3.5)	(3.6)	(4.4)	(2.8)	(2.1)	(4.6)	(4.8)	(5.3)	(5.6)
Trade balance/GDP	(26.0)	(21.8)	(25.4)	(27.0)	(24.2)	(23.0)	(22.8)	(22.3)	(22.3)	(22.6)
Net FDI/GDP	2.0	2.2	4.6	1.5	3.4	3.4	2.0	2.2	2.2	2.2
Net portfolio equity inflow/GDP	0.2	(0.5)	(0.6)	0.2	(1.1)	0.4	0	0	0	0
Gross external financing needs/CARs plus usable reserves	126.5	120.2	114.5	117.5	115.4	112.9	111.8	112.5	111.0	112.0
Narrow net external debt/CARs	26.9	25.8	24.9	30.0	37.9	33.0	45.1	47.9	48.2	47.2
Net external liabilities/CARs	108.6	88.6	71.7	84.3	97.7	82.4	105.8	111.1	111.1	109.2
Short-term external debt by remaining maturity/CARs	35.9	33.9	25.9	35.0	35.3	28.3	28.6	25.9	22.2	21.1
Reserves/CAPs (months)	1.9	1.7	1.5	2.1	2.3	1.8	2.2	1.9	1.7	1.5
FISCAL INDICATORS (%, General government)										
Balance/GDP	(2.7)	(2.4)	(2.6)	(4.0)	(4.2)	(4.5)	(4.0)	(3.6)	(3.3)	(3.2)
Change in debt/GDP	3.4	1.8	5.0	6.2	2.8	6.0	4.0	3.6	3.3	3.2
Primary balance/GDP	(2.1)	(1.7)	(1.8)	(3.0)	(3.3)	(3.4)	(2.8)	(2.3)	(1.9)	(1.8)
Revenue/GDP	33.1	32.7	32.0	32.6	31.9	31.5	31.0	31.5	32.0	32.2
Expenditures/GDP	35.8	35.1	34.6	36.6	36.1	35.9	35.0	35.1	35.3	35.4

Table 1

Republic of Macedonia Selected Indicators (cont.)										
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Interest /revenues	1.8	2.2	2.4	2.8	3.1	3.2	3.7	4.1	4.3	4.5
Debt/GDP	23.9	24.4	28.0	34.3	36.1	40.2	42.5	44.2	45.5	46.6
Net debt/GDP	19.8	21.6	20.1	24.0	26.6	30.6	33.3	35.4	37.1	38.6
Liquid assets/GDP	4.1	2.8	7.9	10.3	9.5	9.6	9.2	8.8	8.4	8.0
MONETARY INDICATORS (%)										
CPI growth	(0.8)	1.6	3.9	3.3	2.8	(0.3)	0	1.5	2.0	2.2
GDP deflator growth	0.7	2.7	3.1	0.1	0.2	1.4	1.3	1.7	2.0	2.0
Banks' claims on resident private sector growth	3.4	7.4	8.4	5.3	6.3	10.0	9.0	9.0	8.0	8.0
Banks' claims on resident private sector/GDP	43.8	44.5	45.5	48.0	49.5	51.7	54.0	56.2	57.9	59.8
Foreign currency share of claims by banks on residents	44.1	42.2	42.3	38.5	36.9	34.9	48.3	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. MKD--Macedonian denar. CARs--Current account receipts. FDI--Foreign direct Iivestment. CAPs--Current account payments. N/A--Not applicable. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Macedonia Ratings Score Snapshot	
Key rating factors	
Institutional assessment	Weakness
Economic assessment	Weakness
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Neutral
Monetary assessment	Neutral

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Sovereign Risk Indicators - Oct. 12, 2015. An interactive version is also available at http://www.spratings.com/sri.
- Who's At Risk? Emerging Market Sovereigns Are Facing Adverse Global Trends - September 29, 2015
- Central, Eastern, and Southeastern Europe Sovereign Rating Trends Mid-Year 2015 - July 13, 2015
- Global Sovereign Rating Trends Mid-Year 2015 - July 13, 2015
- 2014 Annual Sovereign Default Study And Rating Transitions - May 18, 2015
- Global Sovereign Debt Report 2015: Borrowing To Drop By 5.7% To US$6.7 Trillion - March 05, 2015
- Central And Eastern Europe Debt Report 2015: Borrowing To Decrease To EUR119 Billion - March 05, 2015

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the monetary assessment had improved. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Ratings	
	To	From
Macedonia (Republic of)		
Sovereign credit rating		
Foreign and Local Currency	BB-/Stable/B	BB-/Stable/B
Transfer & Convertibility Assessment	BB	BB
Senior Unsecured		
Foreign and Local Currency	BB-	BB-

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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