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Ratings

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Research Update:

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

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Key Statistics

Ratings Score Snapshot

Related Criteria And Research

Ratings List

Research Update:

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Overview

- Macedonia remains mired in a political crisis that has taken its toll on the domestic economy and public finances, but may end with elections scheduled for December 2016.
- We are affirming our 'BB-/B' sovereign credit ratings on Macedonia.
- The stable outlook reflects the balance between the risks from Macedonia's rising public and external debt against the country's economic prospects, which benefit from recurrent investment inflows.

Rating Action

On Sept. 30, 2016, S&P Global Ratings 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 the country's relatively low income and wealth levels; weak checks and balances between state institutions, which are exacerbated by the prolonged political crisis; 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.

Macedonia's political crisis continues to drag on. Early elections, initially scheduled for April 2016 and then postponed until June 2016, were again called off and are now slated for December 2016. Although in late August both major political parties, VMRO-DPMNE and the opposition SDSM, agreed that the necessary preconditions for free and fair elections had been met, most notably the cleanup of the electoral roll and progress toward freer media, another postponement of the December election cannot be ruled out, given how protracted Macedonia's political crisis has been. We consider the ratings on Macedonia to be constrained by weak institutional and governance effectiveness, resulting from lack of progress in the areas of public financial management, media freedom, and the independence of the judiciary. Insufficient reform progress, combined with the ongoing conflict with Greece over its constitutional name, make Macedonia's EU accession during our forecast horizon to 2019 unlikely, in our view.

The protracted political crisis has taken its toll on Macedonia's economy and we're lowering our real GDP growth forecast to 2.3% in 2016 from 3.3% in our previous review. While exports continue to grow strongly as foreign companies expand their production capacities in the country's free economic zones, domestic demand growth, most notably investments, has decelerated compared with last year. Foreign investors seem largely shielded from the political uncertainty due to their special tax-exempt status, but the postponement of elections may have dampened sentiment among domestic companies. If elections take place in December, we expect a rebound in investments, especially from domestic companies, over the next few years, which alongside continued robust export growth supports our average GDP growth forecast of 2.8% over 2017-2019. Greater synergies between the free economic zones and the domestic economy could drive growth while improving the unemployment rate, which remains among the highest in Europe at 26% on average in 2015 (see "Sovereign Risk Indicators," published July 6, 2016; also at www.spratings.com/sri) although it dropped to 24.2% in the second quarter of 2016, indicative of Macedonia's large informal sector and continued reliance on remittances.

The August floods in the Skopje region have led the government to once again present a supplementary budget, the second one this year. We are therefore revising our general government deficit forecast upward to 4.1% of GDP from 3.4% in our last review. Without stronger consolidation measures and improvements in the fiscal framework, including a track record of credible budgetary assumptions, especially on economic growth; and fiscal rules enshrined in law, the deficit will average 3.3% of GDP in our base case for 2017-2019. In part, these deficits also reflect the government's investment program, which is driven by the country’s infrastructure needs but also by less-productive investments, such as the "Skopje 2014" program.

The slow pace of fiscal consolidation will also lead to an increasing debt burden over 2016-2019, in our view. Gross general government debt, while still relatively low, has more than doubled since the global financial crisis began and we expect it will stand at about 45% of GDP in 2016. In contrast to Macedonia's official statistics, our general government debt calculation includes the increasing debt of The Public Enterprise for State Roads (PESR), which the government moved off the balance sheet in 2013. This is because we believe that PESR will continue to rely on government transfers and guarantees. In particular, a €580 million loan from the Export-Import Bank of China, contracted in 2013 for the construction of two highway sections, will continue to contribute to a mounting debt burden over the coming years. In addition, off-balance-sheet financing pushed up the stock of guaranteed debt to 8.3% of GDP in 2016 including 3.6% of GDP that is attributable to PESR, which we already include in general government debt. Nonetheless, Macedonia's remaining external refinancing needs have been relatively contained this year, due to a successful Eurobond issuance in July 2016, which should partly prefund the 2017 repayments

As a result of the repeat Eurobond issuance, Macedonia's government debt profile is exposed to risk. 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, even though the Macedonian denar's peg to the euro reduces the risk. In addition, about 35% of Macedonia's general government debt is at floating interest rates. That said, the banking system holds, on average, about 12% of its assets in government securities and central bank bills, giving the government the flexibility to rely on domestic issuance should external markets become more volatile.

With the public sector increasingly borrowing abroad, Macedonia's external debt has been rising, despite deleveraging in the banking sector. In 2015, narrow net external debt (gross external debt less liquid financial sector assets) increased to just over 40% of current account receipts. We expect Macedonia's external debt metrics will gradually improve, supported by robust growth of current account receipts and moderate current account deficits of 1.4% of GDP on average between 2016 and 2019. These deficits will be financed by external borrowing and, to a lesser extent, foreign investment flows, in our view. However, about 30% of the foreign direct investment inflow is in the form of debt-like instruments and therefore has lower barriers to exit. In addition, we expect the current account deficit will widen to 1.8% of GDP by 2019 as investment-related imports pick up.

The Macedonian denar is pegged to the euro. At about $2.7 billion, Macedonia's foreign reserves cover the monetary base by about 2x, implying strong backing for the pegged currency regime. The exchange rate regime restricts monetary policy flexibility. However, central bank measures, such as lower reserve requirements for denar-denominated liabilities, have succeeded in lowering overall euro-ization in Macedonia, with foreign currency-denominated deposits and claims remaining below 50% of total deposits and claims, down from a peak of 56% in 2005. Rather exceptionally for the region, bank lending in Macedonia--including to corporations--has continued to increase (by about 9.5% in 2015), with the loan-to deposit ratio estimated at about 90% at midyear 2016.

Macedonia's banking system has seen several bouts of volatility in recent years. Last year, the crisis in Greece put some pressure on Stopanska Banka, a subsidiary of the National Bank of Greece S.A. This year, political developments caused deposit outflows from Macedonia's banking sector in April, although the majority of funds have since flowed back into the system. In general, the banking system seems well capitalized and profitable, and it is largely funded by domestic deposits. Macedonia's regulatory and supervisory framework under the National Bank of the Republic of Macedonia (NBRM) has proven successful and resilient in weathering these episodes of volatility; the NBRM reacted swiftly to the volatility in April by raising interest rates and intervening in the foreign exchange market to support the currency peg. In addition, this year the NBRM introduced macroprudential measures, such as higher capital requirements for consumer loans longer than eight years, to prevent the buildup of credit risk in that segment. Moreover, the NBRM has forced banks to write down nonperforming loans (NPLs) that had been fully provisioned and in arrears for more than two years, reducing the NPL ratio to 7.6% of total loans in July 2016 from 10.8% at the end of 2015.

Outlook

The stable outlook reflects the balance between the risks we see from Macedonia's rising public and external debt against the country's economic prospects, which benefit from recurrent investment inflows.

We could raise our ratings on Macedonia if reforms directed toward higher broader-based growth led to a faster increase in income levels than in our base-case scenario, alongside improved effectiveness and accountability of public institutions.

We could lower our ratings if large fiscal slippages or off-budget activities were to call into question the sustainability of Macedonia's public debt, raise the sovereign's borrowing costs, and substantially increase its external obligations, given the constraints of the exchange-rate regime. In addition, if the parent companies of systemically important banks operating in Macedonia were to cut their exposure to subsidiaries, heightening pressure on the banking sector's liquidity and external finances, we could consider a negative rating action.

Key Statistics

Table 1

Republic of Macedonia Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	437	464	467	502	526	560	583	612	641	673
Nominal GDP (bil. $)	9	10	10	11	11	10	10	11	11	12
GDP per capita (000s $)	4.6	5.1	4.7	5.2	5.5	4.9	5.1	5.1	5.4	5.6
Real GDP growth	3.4	2.3	(0.5)	2.9	3.5	3.7	2.3	2.9	2.8	2.8
Real GDP per capita growth	3.2	2.1	(0.6)	2.8	3.4	3.5	2.1	2.7	2.6	2.6
Real investment growth	(3.8)	17.9	10.2	0.5	13.1	0.1	0.4	3.0	3.0	3.0
Investment/GDP	24.5	26.9	28.9	28.8	30.5	31.9	25.6	26.6	27.7	28.8
Savings/GDP	22.4	24.4	25.7	27.2	29.5	30.5	24.4	25.3	26.4	27.1
Exports/GDP	39.8	47.1	45.4	43.4	47.8	48.5	53.1	55.5	57.8	59.6
Real exports growth	23.7	16.1	2.0	6.1	18.2	4.6	9.5	6.5	6.0	6.0
Unemployment rate	32.0	31.4	31.0	29.0	28.0	26.1	25.4	25.1	24.8	24.5
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(2.1)	(2.5)	(3.3)	(1.6)	(0.9)	(1.4)	(1.2)	(1.3)	(1.3)	(1.8)
Current account balance/CARs	(3.5)	(3.6)	(4.8)	(2.5)	(1.3)	(2.0)	(1.6)	(1.8)	(1.7)	(2.2)
Trade balance/GDP	(21.6)	(25.2)	(26.5)	(22.9)	(21.8)	(20.0)	(20.3)	(19.8)	(20.0)	(20.4)
Net FDI/GDP	2.2	4.5	1.7	2.8	2.3	1.9	2.0	2.2	2.2	2.2
Net portfolio equity inflow/GDP	(0.5)	(0.6)	0.2	(1.0)	0.4	(0.3)	0.0	0.0	0.0	0.0
Gross external financing needs/CARs plus usable reserves	118.5	114.5	117.8	115.2	112.2	111.9	111.8	109.1	106.4	104.1
Narrow net external debt/CARs	25.8	24.9	30.1	37.7	34.3	40.4	35.9	36.0	34.8	34.6
Net external liabilities/CARs	88.6	71.7	84.6	97.3	79.8	88.9	80.7	79.5	75.1	72.6
Short-term external debt by remaining maturity/CARs	33.9	25.9	35.2	35.1	28.2	30.9	24.9	22.3	21.4	19.1
Reserves/CAPs (months)	1.8	1.5	2.1	2.3	1.8	2.2	1.6	1.6	1.9	1.9
FISCAL INDICATORS (%, General government)										
Balance/GDP	(2.4)	(2.6)	(3.9)	(4.0)	(4.2)	(3.4)	(4.1)	(3.4)	(3.4)	(3.3)

Table 1

Republic of Macedonia Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Change in debt/GDP	1.8	4.9	6.1	3.8	6.9	3.2	5.2	4.5	4.9	3.3
Primary balance/GDP	(1.7)	(1.8)	(3.0)	(3.1)	(3.3)	(2.3)	(2.8)	(2.0)	(1.9)	(1.7)
Revenue/GDP	32.5	31.7	32.1	30.1	29.8	30.9	31.1	31.4	32.2	32.2
Expenditures/GDP	34.9	34.2	36.0	34.1	34.0	34.3	35.2	34.8	35.6	35.5
Interest /revenues	2.2	2.4	2.8	3.1	3.2	3.7	4.1	4.5	4.6	4.9
Debt/GDP	24.2	27.7	33.7	35.1	40.4	41.1	44.8	47.1	49.8	50.8
Debt/Revenue	74.5	87.5	105.1	116.7	135.6	133.1	143.9	150.0	154.7	157.8
Net debt/GDP	21.5	19.9	23.6	26.2	31.3	36.2	40.0	42.6	45.5	46.7
Liquid assets/GDP	2.8	7.8	10.1	8.9	9.1	4.9	4.8	4.5	4.3	4.1
MONETARY INDICATORS (%)										
CPI growth	1.6	3.9	3.3	2.8	(0.3)	(0.3)	0.0	1.4	2.2	2.2
GDP deflator growth	2.0	3.7	1.0	4.5	1.1	2.8	1.7	2.0	2.0	2.0
Exchange rate, year-end (LC/$)	46.3	47.5	46.7	44.6	50.6	56.4	56.5	58.6	56.5	56.5
Banks' claims on resident non-gov't sector growth	7.4	8.4	5.3	6.3	10.0	9.5	4.0	5.0	4.9	4.9
Banks' claims on resident non-gov't sector/GDP	44.1	45.1	47.2	46.7	49.0	50.3	50.3	50.3	50.3	50.3
Foreign currency share of claims by banks on residents	19.4	21.6	19.7	18.9	18.1	17.8	23.5	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	53.1	50.2	47.8	44.8	41.9	41.7	40.7	39.7	38.7	37.7
Real effective exchange rate growth	(2.7)	1.6	(0.5)	2.3	(0.2)	(2.3)	N/A	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. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' 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	Strength
Monetary assessment	Neutral

S&P Global Ratings' 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 S&P Global Ratings' "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 S&P Global Ratings' 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: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Central And Eastern Europe Debt Report 2016: Commercial Borrowing To Increase By 12% To EUR114 Billion - February 29, 2016
- Central And Eastern Europe Rating Trends Mid-Year 2016, July 13, 2016
- Global Sovereign Rating Trends Mid-Year 2016, July 13, 2016
- Sovereign Risk Indicators - July 6, 2016. An interactive version is available at http://www.spratings.com/sri.
- Why Politics Matters To Sovereign Ratings - November 6, 2015
- How A Liquidity Squeeze At Greek Banks Could Affect Their Subsidiaries In Southeastern Europe - June 24, 2015
- 2015 Annual Sovereign Default Study And Rating Transitions - May 24, 2016

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 all 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

	Rating	
	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 Currency[1]	BB-	BB-
Foreign and Local Currency	BB-	BB-

[1] Dependent Participant(s): Citigroup Global Markets Ltd., Erste Group Bank AG

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. 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 S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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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