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Research Update:

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

Primary Credit Analyst:
Aarti Sakhuja, London (44) 20-7176-7111; aarti.sakhuja@standardandpoors.com

Secondary Contacts:
John B Chambers, CFA, New York (1) 212-438-7344; john.chambers@standardandpoors.com
Felix Ejgel, London (44) 20-7176-6780; felix.ejgel@standardandpoors.com

Analytical Group Contact:
SovereignEurope; SovereignEurope@standardandpoors.com

Table Of Contents

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Overview

- Macedonia's low income levels and high external liquidity requirements are offset by its still-moderate external and public debt burdens, in our view.
- We are therefore affirming our 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on Macedonia.
- The stable outlook reflects our view that the government will use the broader economic recovery to consolidate its fiscal position and that Macedonia's external indebtedness will remain moderate.

Rating Action

On May 9, 2014, 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 estimate per capita GDP at nearly $5,200 in 2014), relatively weak checks and balances between political institutions, and limited monetary policy flexibility. The ratings are supported by moderate, albeit rising, external and public debt levels.

Early parliamentary elections were combined with the second round of presidential elections on April 27 following a dispute between the two partners in the previous coalition government over their presidential candidate. The Internal Macedonian Revolutionary Organization-Democratic Party of Macedonian National Unity (VMRO) won the elections and is just one seat short of a majority. Its coalition partner has historically been the largest ethnic Albanian party, the Democratic Union for Integration (DUI). Despite differences between the two, we expect them to form a coalition again. We anticipate a broad continuation of the government's economic policies, which have prioritized economic growth and employment generation through increased investment, both private and public.

Risks to political stability could arise from tensions between VMRO and the main opposition party, the Social Democratic Alliance of Macedonia (SDSM), or between the VMRO and its junior coalition partner. While we expect tensions to persist throughout the next parliamentary term and do not exclude the possibility of a stalemate between the government and opposition, disruptions to policymaking will be mitigated by VMRO's strong position as the dominant party in government.

We view Macedonia's institutions as having relatively weak checks and balances. In its 2013 progress report on Macedonia, the EU highlighted deteriorating media freedom and problems related to the independence of the judiciary. Freedom House noted widespread graft and misconduct, particularly in public procurement. In our opinion, fiscal slippages and the weakening quality of public finances since the global financial crisis also point to limited checks and balances among Macedonia's political institutions.

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

Macedonia's economy grew by 3.1% in real terms in 2013. Preliminary data from its statistical agency indicates that growth was driven by private consumption and exports--particularly to Germany--while investment contracted. Real export performance was relatively strong at 4.5%, while imports contracted. However, the analysis of growth drivers has been complicated by the statistical restatement of 2012 and 2013 data. We expect real GDP to grow by an annual average of 2.8% over 2014-2017 driven by domestic demand and increasing demand from key export markets. We expect investment activity to be supported by foreign investment inflows, largely to the manufacturing sector.

Unemployment has been on a decreasing trend in recent years but still remains high at an estimated 28.7% in September 2013. Youth unemployment is particularly high in the 15-24 age group at nearly 54% in 2012.

We anticipate that in 2014-2017 the government will reverse its expansionary fiscal stance of recent years--helped in its efforts by strengthening private consumption and investment activity. We estimate that the general government deficit will narrow to 2.7% of GDP in 2017 from 4.2% in 2013. We expect that the government will finance its deficits through a mix of domestic and external debt. Given our assumptions on growth and deficits, we estimate general government debt net of fiscal assets to rise to 33% of GDP in 2017 from an estimated 26% in 2013.

More than 70% of government debt is denominated in foreign currency. The banking system holds, on average, about 15% of its assets in government securities and central bank bills. As such, we do not view it as being able to materially increase its creditor share of the domestic government bond market because of its own balance sheet constraints.

The indebtedness of some of Macedonia's public-sector enterprises is rising as they play a greater role in advancing the government's policy objectives. The Public Enterprise for State Roads (PESR), which the government moved off-budget in 2013, contracted a €580 million (7% of 2014 GDP) loan from the

Export-Import Bank of China. Proceeds from the loan will be used to finance the construction of two motorways totaling 100 kilometers connecting towns in the country's east and west. The loan, guaranteed by the government, is likely to be disbursed in tranches over 2014-2017. Repayments will likely be over a 15-year period beginning in 2019. As a result, we expect the stock of government guarantees to increase toward 10.0% of GDP in 2017 from 6.5% at the end of 2013.

We expect the current account deficit, which narrowed to just under 2% of GDP in 2013, to widen to nearly 6% of GDP in 2017, driven by a pick-up in investment-related imports. We expect the current account deficit to be financed primarily by external debt and net FDI.

The Macedonian banking system is largely funded by domestic deposits and appears well-capitalized--the reported capital adequacy ratio averaged 16.8% in December 2013. Despite an improvement in the last two quarters of 2013, nonperforming loans still remained elevated at 11.5% of gross loans in December 2013 (compared to 6.8% in December 2008). Two of the three banks that we view as systemically important in the domestic banking sector have constrained foreign parents, exposing these subsidiaries to parent-level disruptions, in our opinion. Stopanska Banka AD's parent is Greece-based National Bank of Greece S.A. and NLB Tutunska Banka AD's parent is Slovenia-based Nova Ljubljanska Banka. In our opinion, the Macedonian regulatory and supervisory framework has appropriate policies in place to address liquidity risks associated with potential withdrawals by parent banks.

The Macedonian denar is pegged to the euro. The exchange rate regime, along with the high proportion of loans and deposits denominated in euros--albeit declining in recent years--restricts monetary policy flexibility. In December 2013, 53% of total deposits and 48% of loans were denominated in or indexed to foreign currency.

Outlook

The stable outlook reflects our view that the government will use the broader economic recovery to consolidate its fiscal position and that Macedonia's external indebtedness will remain moderate. We don't expect that any of the key rating factors will move in either direction such that it would lead us to revise our ratings on Macedonia within the next 12 months.

We could raise the ratings if reforms directed toward higher and more broad-based growth were matched with the improved effectiveness and accountability of public institutions.

We could lower the ratings if large fiscal slippages challenged public debt sustainability and substantially increased external obligations given the constraints of the exchange-rate regime. We could also lower the ratings if we saw that off-budget activities were to increase significantly and the probability of contingent liabilities crystallizing on the government's balance sheet were to rise.

Key Statistics

Table 1

Republic of Macedonia - Selected Indicators											
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013e**	**2014f**	**2015f**	**2016f**	**2017f**
Nominal GDP (US$ bil)	8	10	9	9	10	10	10	11	11	11	12
GDP per capita (US$)	3,996	4,808	4,546	4,549	5,053	4,649	4,956	5,180	5,242	5,543	5,817
Real GDP growth (%)	6.1	5.0	(0.9)	2.9	2.8	(0.4)	3.1	2.5	2.8	3.0	3.0
Real GDP per capita growth (%)	6.0	4.8	(1.1)	2.7	2.5	(0.5)	3.0	2.4	2.6	2.9	2.9
Change in general government debt/GDP (%)	(4.0)	(0.9)	3.4	1.8	5.0	6.3	2.3	2.6	3.1	3.4	3.1
General government balance/GDP (%)	(0.9)	(1.1)	(2.7)	(2.4)	(2.6)	(4.0)	(4.2)	(3.7)	(3.3)	(3.0)	(2.7)
General government debt/GDP (%)	24.0	20.4	23.9	24.4	28.0	34.3	35.5	36.5	38.1	39.6	40.8
Net general government debt/GDP (%)	17.7	16.5	19.8	21.6	20.1	24.0	26.0	28.6	30.7	32.2	33.4
General government interest expenditure/revenues (%)	2.5	2.1	1.8	2.2	2.4	2.8	3.1	3.7	4.4	4.6	4.7
Oth dc claims on resident non-govt. sector/GDP (%)	35.4	42.2	43.8	44.5	45.5	48.0	49.4	50.3	51.4	52.3	53.3
CPI growth (%)	2.3	8.3	(0.8)	1.6	3.9	3.3	2.8	2.5	3.0	3.0	3.0
Gross external financing needs/CARs +use. res (%)	110.0	124.0	124.5	117.4	114.8	117.5	115.6	112.2	114.4	114.4	116.2

Table 1

Republic of Macedonia - Selected Indicators (cont.)											
Current account balance/GDP (%)	(7.4)	(12.6)	(6.5)	(2.1)	(2.5)	(3.1)	(1.9)	(2.3)	(3.9)	(5.0)	(5.7)
Current account balance/CARs (%)	(10.3)	(18.2)	(11.3)	(3.1)	(3.3)	(4.0)	(2.5)	(3.0)	(5.0)	(6.3)	(7.1)
Narrow net external debt/CARs (%)	5.5	15.2	22.5	21.9	20.6	25.8	33.0	31.7	32.0	31.7	32.4
Net external liabilities/CARs (%)	59.3	67.7	95.7	79.8	64.1	76.1	88.6	86.0	88.2	88.5	90.2

Other depository corporations (dc) are financial 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. CARs--Current account receipts.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria for Determining Transfer and Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Defaults And Rating Transition Data, 2013 Update, April 18, 2014
- Emerging Europe Sovereign Ratings Remain Vulnerable To Political And Fiscal Pressures, Sept. 11, 2013
- Emerging Market Sovereigns In Europe Could Be Most At Risk In A Liquidity Squeeze, July 4, 2013

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 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.

Ratings List

Ratings Affirmed

Macedonia (Republic of)	
Sovereign Credit Rating	BB-/Stable/B
Transfer & Convertibility Assessment	BB
Senior Unsecured	BB-

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