S&P Global
Ratings

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Research Update:

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

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

Ratings:
Foreign and Local Currency: BB-/Stable/B

For further details see ratings list.

Overview

- The political crisis in Macedonia has receded following the formation of a narrow majority coalition government in May 2017.
- We anticipate a reasonable degree of policy continuity, which should support a gradual acceleration in economic growth in the near term.
- We are affirming our 'BB-/B' ratings on Macedonia.
- The stable outlook reflects the balance between the risks from Macedonia's rising public debt and remaining political uncertainty over the next 12 months, and the country's favorable economic prospects.

Rating Action

On Sept. 15, 2017, S&P Global Ratings affirmed its long- and short-term foreign and local currency sovereign credit ratings on the Republic of Macedonia at 'BB-/B'. The outlook for the long-term ratings remains stable.

Outlook

The stable outlook reflects the balance between the risks from Macedonia's rising public debt and remaining political uncertainty over the next 12 months, and the country's favorable economic prospects.

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

We could lower the ratings if major political tensions returned, impairing growth and foreign direct investment (FDI) inflows and undermining the country's longer-term prospects. We could also lower the 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 reduce their commitment to subsidiaries, we could consider a negative rating action.

Rationale

The ratings on Macedonia reflect our view of the country's relatively low income levels; comparatively weak checks and balances between state institutions, coupled with the still-fragile political environment; and limited monetary policy flexibility arising from the country's fixed-exchange-rate regime. The ratings are primarily supported by moderate—albeit rising—external and public debt levels.

Institutional and Economic Profile: The formation of a coalition government should support a gradual acceleration in growth following output contraction in the first half of 2017

- A narrow majority coalition government was finally formed in May 2017, more than half a year after the latest general election.
- In our view, the development should support improved confidence and a gradual acceleration in economic growth.
- We do not expect a substantial change in policy direction under the new administration.

A government centered around the Social Democratic Union of Macedonia (SDSM)—the main former opposition party—was finally formed in May 2017. The coalition also features two other parties that represent the Albanian minority—the Democratic Union for Integration (DUI) and Alliance for Albanians (AA). The formation of the government comes more than six months after snap elections were held in December 2016. Although the incumbent party, Internal Macedonian Revolutionary Organization-Democratic Party for Macedonian National Unity (VMRO-DPMNE) secured the largest proportion of the vote at the time, it failed to secure enough parliamentary support to govern for another term.

Macedonia has been locked in a protracted political crisis and, in our view, the recent government formation should help bring more certainty and improvement in economic sentiment. At the same time, it remains to be seen whether and how long the new arrangement will last, given the narrow majority of only two seats commanded by the administration. Historically, Macedonia has frequently seen bouts of political volatility and out-of-cycle elections.

At the same time, we do not expect recent political changes to bring about a major shift in policy direction. The new government will likely remain focused on Macedonia's accession to NATO and the EU, although progress will be only gradual. We also do not anticipate a radical change in Macedonia's fiscal stance and its moderate budgetary deficits are expected to persist over the four-year forecast horizon.

Although the recent post-election power transfer establishes an important precedent in Macedonia, we still believe the country's institutional arrangements remain comparatively weak. We note that effective checks and balances between government bodies are often lacking. There also remains a risk of tensions between ethnic Macedonians and the Albanian minority, as highlighted by the protests that took place earlier this year.

Nevertheless, the respite in political uncertainty should support an improvement in confidence and economic sentiment. The political crisis has already taken a toll on the economy, with growth slowing to 2.4% in 2016 from almost 4% in 2015, followed by

an output contraction in year-on-year terms in the first half of 2017 as some private and public investments were put on hold.

We anticipate this drop to have been temporary and expect growth to strengthen in the second half of this year, resulting in an overall output expansion of 1% in 2017. It should accelerate further, averaging about 3% in 2018-2020 supported by rising investments, consumption, and net exports.

Downside risks to our forecasts remain, not least if the political crisis intensifies again. With GDP per capita estimated at about $5,400 in 2017, Macedonia remains a low-income economy. In recent years, the government has attempted to attract FDI to special free economic zones, capitalizing on the country's comparatively favorable tax regime, low labor costs, and proximity to European markets. In our view, were major political tensions to return, this could weigh on growth if a substantial portion of foreign investments are cancelled or postponed.

Political risks aside, we believe there is upside potential for the economy's long-term growth prospects from the expansion of free zones. Full benefits to growth would only materialize, however, if companies within the zones become better integrated into the local economy by using local suppliers. We note that so far most inputs for goods assembled by foreign companies have been imported. Consequently, the free zones' impact on the rest of the economy has been less than might be expected and largely confined to employment.

Flexibility and Performance Profile: Although the public debt burden remains moderate, leverage will continue rising in line with projected fiscal deficits.

- Macedonia's public debt burden remains moderate in a global context.
- Nevertheless, the projected deficits will add to the country's debt stock, and we forecast general government debt (including obligations of the Public Enterprise for State Roads) will rise to about 51% of GDP by 2019.
- Although Macedonia's monetary flexibility is higher than that of other Balkan states, the denar-euro peg constrains the policies of the National Bank of the Republic of Macedonia (NBRM).

Macedonia has been running persistent budget deficits, but we believe its fiscal profile still leaves some space for policy flexibility, which supports the ratings. Over the longer run, the new government aims for a gradual fiscal consolidation with deficit reducing toward 2% of GDP over the next four years. However, the consolidation plan so far lacks concrete measures and could fall short of the target if growth or revenue collection underperform. Consequently, we forecast slightly wider deficits averaging 3% of GDP over the next four years.

Following the formation of a new government, a supplementary 2017 budget was adopted at the beginning of August, whereby both revenue and expenditure projections were revised downward. The amended budget is based on more modest economic growth assumptions and aims to reduce less productive spending as well downsize capital expenditures. The authorities' general government deficit target for 2017 is 3% of GDP, which we think is broadly achievable.

The general government deficit amounted to 2.6% of GDP last year—lower than the authorities' revised target of 4%. Importantly, however, this has largely happened against the background of underspending, partly attributable to the political stalemate.

We also believe that while net general government debt remains comparatively low, it will continue to rise to 46% of GDP in 2020 from an estimated 38% of GDP at year-end 2016. Our general government debt calculation includes the increasing debt of The Public Enterprise for State Roads (PESR). This is because we believe PESR will need to rely on government transfers to service its debt in the future. In particular, a €580 million loan from the Export-Import Bank of China (and for which the government provided a guarantee), contracted in 2013 for the construction of two highway sections, will continue to contribute to the increasing debt burden.

Macedonia has repeatedly been able to tap the Eurobond market. This has made the government's balance sheet more vulnerable to potential foreign-exchange movements, as close to 80% of government debt is denominated in foreign currency (including part of domestic debt). The authorities plan to expand their domestic issuance but also maintain regular foreign capital market borrowing.

With the public sector increasingly borrowing abroad, the Macedonian economy's external debt has been rising despite some deleveraging in the banking sector. In 2016, we estimate that gross external debt net of liquid financial and public-sector assets increased to about 30% of current account receipts.

We forecast that Macedonia's external debt metrics will remain broadly stable over the next four years. We anticipate the current account deficit will gradually tighten and reach 2% of GDP in 2020, partly owing to the positive impact of the expansion of foreign companies in the free zones. We project these deficits will be financed by a combination of borrowing and net FDI inflows.

The Macedonian denar is pegged to the euro, and we believe the existing foreign-exchange regime restricts monetary policy flexibility. However, central bank measures, such as lower reserve requirements for denar-denominated liabilities, have lowered overall euroization in Macedonia, with foreign currency-denominated deposits and loans remaining around 40% of total deposits and loans in recent years. We note that this is a lower proportion than in other Balkan economies and affords the NBRM additional room for policy response. Rather exceptionally for the region, bank lending in Macedonia has also continued to increase in recent years. That said, the trends are uneven: while lending to households has been robust, the stock of credit to corporates has remained flat. We expect the stock of domestic credit to grow by a moderate annual average of 5% over the next four years.

Macedonia's banking system, which is predominantly foreign-owned, has seen several bouts of volatility in recent years. For example, political developments caused deposit outflows from Macedonia's banking sector in April 2016, although the majority of funds have since flowed back into the system. In general, the banking system appears well capitalized and profitable, and it is largely funded by domestic

deposits. Macedonia's regulatory and supervisory framework under the NBRM has proven resilient to past 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 as well as deploying several other measures. In addition, the NBRM has introduced macroprudential measures such as higher capital requirements for consumer loans longer than eight years and is moving ahead with the implementation of Basel III principles. At present, we estimate that nonperforming loans in the system amount to about 7% of the total.

Key Statistics

Table 1

Republic of Macedonia Selected Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	464	467	502	528	558	607	623	652	687	729
Nominal GDP (bil. $)	10	10	11	11	10	11	11	12	13	14
GDP per capita (000s $)	5.1	4.7	5.2	5.5	4.9	5.3	5.4	5.8	6.1	6.6
Real GDP growth	2.3	(0.5)	2.9	3.6	3.8	2.4	1.0	2.7	2.8	3.0
Real GDP per capita growth	2.1	(0.6)	2.8	3.5	3.7	2.3	0.9	2.6	2.7	2.9
Real investment growth	17.9	10.2	0.5	10.7	3.6	(4.3)	0.0	2.5	2.5	2.5
Investment/GDP	26.9	28.9	28.8	30.3	31.1	33.6	33.4	33.3	32.7	31.9
Savings/GDP	24.4	25.7	27.2	29.7	29.1	30.4	30.2	30.6	30.6	30.0
Exports/GDP	47.1	45.4	43.4	47.7	48.8	49.2	52.9	55.6	58.1	60.4
Real exports growth	16.1	2.0	6.1	16.5	6.7	11.5	8.0	7.0	6.0	6.0
Unemployment rate	31.4	31.0	29.0	28.0	26.1	23.7	22.0	21.0	20.5	20.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(2.5)	(3.3)	(1.6)	(0.6)	(2.0)	(3.1)	(3.2)	(2.6)	(2.1)	(1.9)
Current account balance/CARs	(3.6)	(4.8)	(2.5)	(0.9)	(2.9)	(4.6)	(4.5)	(3.6)	(2.8)	(2.5)
CARs/GDP	68.3	68.7	65.4	69.1	68.8	67.3	71.1	73.3	75.6	77.6
Trade balance/GDP	(25.2)	(26.5)	(22.9)	(21.7)	(20.1)	(18.8)	(19.6)	(19.2)	(18.5)	(17.8)
Net FDI/GDP	4.5	1.7	2.8	2.3	2.3	3.6	1.7	2.0	2.5	2.5
Net portfolio equity inflow/GDP	(0.4)	(0.2)	(0.4)	(0.4)	(0.4)	(0.2)	(0.3)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	114.9	117.6	114.2	111.9	111.7	113.6	112.8	115.0	114.8	114.9
Narrow net external debt/CARs	24.7	27.7	29.2	25.1	26.9	29.3	31.1	30.5	29.4	28.4
Net external liabilities/CARs	71.5	82.3	88.8	70.4	80.3	82.3	80.4	76.6	73.7	70.4
Short-term external debt by remaining maturity/CARs	24.0	32.4	31.9	25.8	27.1	21.7	22.0	20.8	19.9	19.0
Usable reserves/CAPs (months)	1.3	1.9	2.1	1.6	1.9	1.3	1.4	0.9	0.8	0.7
Usable reserves (mil. $)	1,113	1,253	1,034	1,137	825	960	719	668	606	605
FISCAL INDICATORS (%, General government)										
Balance/GDP	(2.6)	(3.9)	(4.0)	(4.2)	(3.4)	(2.6)	(3.0)	(3.5)	(3.5)	(3.0)

Table 1

Republic of Macedonia Selected Indicators (cont.)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Change in debt/GDP	4.9	6.1	4.4	6.8	3.1	5.4	4.0	4.4	4.4	3.0
Primary balance/GDP	(1.8)	(3.0)	(3.1)	(3.2)	(2.3)	(1.5)	(1.6)	(2.1)	(2.0)	(1.5)
Revenue/GDP	31.7	32.1	30.1	29.7	31.0	29.9	29.5	29.5	29.5	29.5
Expenditures/GDP	34.2	36.0	34.1	33.9	34.4	32.5	32.5	33.0	33.0	32.5
Interest /revenues	2.4	2.8	3.1	3.3	3.8	3.8	4.6	4.8	5.0	5.2
Debt/GDP	27.7	33.7	35.7	40.7	41.6	43.6	46.5	48.9	50.8	50.9
Debt/Revenue	87.5	105.1	118.8	137.2	134.3	145.8	157.7	165.6	172.1	172.4
Net debt/GDP	22.9	26.6	29.4	33.2	36.4	37.7	40.7	43.3	45.5	45.9
Liquid assets/GDP	4.9	7.1	6.3	7.5	5.2	5.9	5.8	5.5	5.3	5.0
MONETARY INDICATORS (%)										
CPI growth	3.9	3.3	2.8	(0.3)	(0.3)	(0.2)	1.0	1.6	2.2	2.5
GDP deflator growth	3.7	1.0	4.5	1.4	1.9	6.3	1.5	2.0	2.5	3.0
Exchange rate, year-end (LC/$)	47.53	46.65	44.63	50.56	56.37	58.33	54.96	54.47	53.99	53.52
Banks' claims on resident non-gov't sector growth	8.4	5.2	6.3	9.9	9.5	1.1	3.0	5.0	6.0	6.0
Banks' claims on resident non-gov't sector/GDP	44.9	47.0	46.5	48.6	50.3	46.7	46.9	47.0	47.3	47.3
Foreign currency share of claims by banks on residents	56.0	51.4	47.9	44.9	42.5	42.1	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	48.9	45.7	43.3	40.5	40.6	41.2	N/A	N/A	N/A	N/A
Real effective exchange rate growth	0.4	0.1	1.6	1.0	(0.3)	1.2	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. 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	Neutral
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: Criteria For Determining Transfer And Convertibility Assessments - May 18,2009
- General Criteria: Use Of CreditWatch And Outlooks - September 14,2009
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07,2017

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 economic 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

	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 and Local Currency	BB-	BB-

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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