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Research Update:

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

Primary Credit Analyst:
Maxim Rybnikov, London (44) 20-7176 7125; maxim.rybnikov@spglobal.com

Secondary Contacts:
Sabine Daehn, Frankfurt (49) 69-33-999-244; sabine.daehn@spglobal.com
Fabio Manfredonia, London (44) 20-7176-3768; Fabio.Manfredonia@spglobal.com

Research Contributor:
Himani Joshi, CRISIL Global Analytical Center, an S&P affiliate, Mumbai

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Ratings

Foreign Currency: BB-/Stable/B
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Overview

- Domestic political instability in Macedonia has receded over the last year, but uncertainties remain, including from the upcoming referendum on the country's name at the end of September.
- In line with our previous expectations, Macedonia's economy has returned to growth following stagnation in 2017.
- We are affirming our 'BB-/B' ratings on Macedonia.
- The outlook is stable.

Rating Action

On Sept. 14, 2018, S&P Global Ratings affirmed its 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on Macedonia. The outlook on the long-term ratings is stable.

Outlook

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

We could raise our ratings on Macedonia if timely reforms are implemented and further progress is made in resolving the longstanding name dispute with Greece, and these lead to the country's economic prospects improving and strengthen Macedonia's likelihood of EU accession.

We could lower the ratings if major political tensions returned or reform momentum waned, impairing growth and foreign direct investment (FDI) inflows and undermining the country's longer-term growth potential. 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.

Rationale

The ratings on Macedonia reflect our view of the country's relatively low income levels, still comparatively weak checks and balances between state institutions, 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 and favorable growth potential.

Institutional and Economic Profile: Growth has strengthened but political risks remain

- The coalition centered around the Social Democratic Union of Macedonia (SDSM) has recently bolstered its parliamentary standing and now commands a stronger majority in the legislature, reducing political uncertainty.
- Uncertainties remain around the upcoming referendum on the country's name at the end of September.
- Despite lagging public investment, growth has strengthened with output expanding by 3.1% in the second quarter of 2018 compared with stagnation last year.

In our view, domestic political stability in Macedonia has improved over the last year. Previously, Macedonia endured a long period of political volatility, culminating in early elections at the end of 2016, and a subsequent parliamentary gridlock. The new administration led by the SDSM was formed in May 2017 and announced as its main priorities EU and NATO accession, alongside improved transparency and reform implementation.

The government initially relied on support from the Democratic Union for Integration, an Albanian minority party, and controlled only a slim majority in the parliament. More recently, other Albanian parties, The Democratic Party of Albanians and BESA, expressed support and bolstered the coalition's parliamentary standing. In our view, this reduces political uncertainty and should make it easier to implement some of the initiatives SDSM has put forward.

We note that progress on some of the announced priorities has already been achieved. For instance, the government took steps to improve the transparency of its fiscal accounts. The new administration has also made notable progress toward resolving the decades-long name dispute with Greece, which is central for Macedonia's NATO and EU accession. In June 2018, the governments of the two countries reached a preliminary deal, whereby Macedonia would change its name to Republic of North Macedonia.

At the same time, it remains uncertain if Macedonia will fully implement the proposed solution. Various steps still need to be completed, including the Sept. 30 referendum in Macedonia and the amendment of the country's constitution, as well as the parliamentary ratification of the agreement in Greece. The outcome of the referendum is currently difficult to predict, and the proposal is facing potential opposition in both countries' parliaments. Failure to pass any of these stages may derail the deal. In addition, this could trigger a new political crisis in Macedonia, given the prime minister's pledge to resign if the referendum does not pass.

A successful resolution of the name dispute, on the other hand, would pave the way for negotiations on Macedonia's accession to the EU and NATO. In our view, the opening of negotiations could bring long-term economic benefits as Macedonia implements reforms required as part of the accession negotiations. Moreover, it could have some short-term economic effects through improved investor confidence and FDI inflows.

Following economic stagnation in 2017, economic growth has recently strengthened to 3.1% in the second quarter of 2018 in year-on-year terms. Importantly, this has happened despite a number of delays on a public highway construction project and declining investments, implying a stronger performance in the rest of the economy. We expect growth will average close to 3% over the next three years, driven by investments in both the private and public sectors, following improved political stability. In addition, we expect a more upbeat dynamic of net exports, thanks to favorable foreign trade conditions and the gradual diversification of Macedonia's export basket.

Downside risks to our forecasts remain, not least if the political instability intensifies again. Macedonia's GDP per capita, estimated at $6,100 in 2018, is well below that of EU peers. 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 FDIs are cancelled or postponed.

Flexibility and Performance Profile: After a period of growth, we expect public debt to GDP to gradually stabilize from 2020

- Macedonia's public debt burden remains moderate in a global context.
- Although downside risks remain, we expect net general government debt to gradually stabilize at about 45% of GDP in 2020-2021 after a prolonged period of growth.
- Macedonia's monetary flexibility is higher than that of other Balkan states, but the denar's peg to the euro still constrains the central bank's policies.

Macedonia has been running recurrent fiscal deficits. These have averaged 3.5% of GDP over the past five years. Even though the shortfalls have reduced to under 3% of GDP in 2016-2017, this primarily reflects underexecution of expenditures as a result of prevailing political uncertainty, rather than pro-active fiscal consolidation.

In May 2018, the SDSM-led government adopted a new fiscal strategy for 2019-2021. The document underscores the focus on budgetary consolidation, improvement of the public finance management framework, and implementation of priority investment projects. According to government projections, the deficit for the general government sector should reduce to 2.0% of GDP in 2021 from the planned 2.7% of GDP in 2018.

In our view, the 2018 target appears achievable. Over the first six months, the deficit amounted to only 0.4% of GDP, although this is once again due to the underexecution of the capital budget. We anticipate that as the spending accelerates through the remainder of the year, the final outcome will be in line with the government's target. We expect slightly wider deficits further on in the forecast horizon, however, averaging 2.7% of GDP as compared against projections in the government's 2019-2021 fiscal strategy.

We believe that some downside risks to fiscal consolidation remain. As was the case in the government's previous fiscal plan announced in December 2017, the new strategy remains significantly dependent on the pace of economic growth. That said, we positively view additional measures the government has proposed:

- The application of higher personal income tax rates for higher income earners, although this could be difficult to implement for political reasons.
- The introduction of annual budget expenditure ceilings, which should restrain expenditure growth.

The authorities also aim to continue public financial management reform with a focus on improved transparency, budgeting processes, and oversight. We understand that work is ongoing to collect information on arrears outstanding at various levels of government.

Reflecting our budgetary forecasts, Macedonia's net general government debt will still continue to rise until 2020, although it should stabilize at close to 45% of GDP thereafter. This compares to net general government debt of just 27% of GDP in 2012. Our calculation includes the increasing debt of the Public Enterprise for State Roads (PESR), because we believe PESR may need to rely on government transfers to service its debt in the future. In particular, a government-guaranteed €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 the increasing debt burden. We also factor in a moderate amount of arrears clearance, assumed at around 1% of GDP.

In the past, 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, because close to 80% of government debt is denominated in foreign currency (including part of domestic debt). Last year, the authorities increased their borrowing in the domestic market, but they have also recently issued a €500 million Eurobond at a historically low interest rate, benefiting from the European Central Bank's loose monetary policy. We believe the favorable terms have also been aided by the improved domestic political stability. In the future, the government plans to maintain a regular presence on international financial markets.

With the public sector increasingly borrowing abroad, the Macedonian economy's external debt has been rising, despite some deleveraging in the banking sector. In 2017, we estimate that gross external debt, net of liquid financial and public-sector assets, increased to about 33% of current account receipts.

We forecast that Macedonia's external indebtedness will slightly decline over the next four years. The current account deficit will gradually tighten and reach 1.6% of GDP in 2021, partly thanks to the positive impact of foreign companies expansion' in the free economic 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, measures undertaken by the National Bank of the Republic of Macedonia (NBRM), such as lower reserve requirements for denar-denominated liabilities, have lowered overall euroization in Macedonia, with foreign currency-denominated deposits and loans remaining at 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.

The NBRM's gross foreign exchange reserves have been on an upward trajectory in recent months, following the Eurobond issue and the purchase of foreign currency. Nevertheless, we believe there are vulnerabilities that could put some pressure on the existing peg in the unlikely event of confidence in the banking system taking a turn for the worse and prompting conversion of local currency deposits into euro. This is particularly so as Macedonia runs a pegged exchange rate arrangement while being in a net external debtor position vis-à-vis the rest of the world, at 60% of GDP.

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 returned to 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 2016 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 moved ahead with the implementation of Basel III principles, while the application of new regulation on credit risk management in line with International Financial Reporting Standard 9 will be rolled out in July 2019. At present, we estimate that nonperforming loans in the system amount to about 5.2% of the total, which compares favorably with other countries in the region.

Rather exceptionally for the region, bank lending in Macedonia has 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 an annual average of 6% over the next four years.

Key Statistics

Table 1

Macedonia Selected Indicators										
(Mil. MKD)	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. MKD)	467	502	528	559	599	620	651	687	728	772
Nominal GDP (bil. $)	10	11	11	10	11	11	13	14	15	16
GDP per capita ($000s)	4.7	5.2	5.5	4.9	5.2	5.5	6.1	6.7	7.1	7.5
Real GDP growth	(0.5)	2.9	3.6	3.9	2.9	0	2.7	3.0	3.0	3.2
Real GDP per capita growth	(0.6)	2.8	3.5	3.7	2.8	(0.1)	2.6	2.9	2.9	3.1
Real investment growth	10.2	0.5	10.7	8.3	13.3	(4.5)	5.5	2.7	2.7	2.7
Investment/GDP	28.9	28.8	30.3	30.4	32.6	31.6	32.8	32.8	33.0	33.1
Savings/GDP	25.7	27.2	29.7	28.5	29.8	30.5	29.8	30.5	31.0	31.5
Exports/GDP	45.4	43.4	47.7	48.7	50.0	55.1	58.0	60.5	63.0	65.3
Real exports growth	2.0	6.1	16.5	8.5	8.1	9.2	7.5	6.0	6.0	5.7
Unemployment rate	31.0	29.0	28.0	26.1	23.7	22.4	21.0	20.5	20.0	20.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(3.3)	(1.6)	(0.6)	(1.9)	(2.8)	(1.1)	(2.9)	(2.3)	(2.0)	(1.6)
Current account balance/CARs	(4.8)	(2.5)	(0.9)	(2.8)	(4.0)	(1.5)	(3.8)	(2.9)	(2.4)	(1.9)
CARs/GDP	68.7	65.4	69.1	68.8	68.9	74.9	77.4	79.2	81.2	82.9
Trade balance/GDP	(26.5)	(22.9)	(21.7)	(20.1)	(18.7)	(17.9)	(18.4)	(17.9)	(17.3)	(16.7)
Net FDI/GDP	1.7	2.8	2.3	2.3	3.3	2.2	3.0	2.5	2.0	1.5
Net portfolio equity inflow/GDP	(0.2)	(0.4)	(0.4)	(0.4)	(0.2)	(0.4)	(0.5)	(0.5)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	113.5	110.5	108.6	108.3	109.9	106.7	113.2	110.9	111.5	111.2
Narrow net external debt/CARs	27.7	29.2	25.1	26.9	28.5	32.8	32.5	31.3	31.0	30.1
Narrow net external debt/CAPs	26.5	28.5	24.9	26.1	27.4	32.3	31.3	30.4	30.3	29.6
Net external liabilities/CARs	82.3	88.8	70.4	80.1	79.4	85.0	79.6	75.6	72.3	69.2
Net external liabilities/CAPs	78.5	86.6	69.8	77.9	76.3	83.7	76.7	73.4	70.6	67.9
Short-term external debt by remaining maturity/CARs	32.4	31.9	25.8	27.1	21.5	20.3	21.1	20.9	20.3	19.4
Usable reserves/CAPs (months)	2.4	2.5	2.0	2.3	1.6	1.7	1.2	1.4	1.2	1.1
Usable reserves (mil. $)	1,526	1,302	1,381	1,055	1,198	1,010	1,294	1,201	1,187	1,155
FISCAL INDICATORS (%, General government)										
Balance/GDP	(3.9)	(4.0)	(4.2)	(3.4)	(2.7)	(2.8)	(2.7)	(3.0)	(2.5)	(2.5)
Change in net debt/GDP	3.9	4.7	5.3	5.0	4.3	3.3	3.8	4.4	3.2	3.1

Table 1

Macedonia Selected Indicators (cont.)

(Mil. MKD)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Primary balance/GDP	(3.0)	(3.1)	(3.2)	(2.3)	(1.5)	(1.5)	(1.4)	(1.6)	(0.9)	(0.6)
Revenues/GDP	32.1	30.1	29.7	31.0	30.3	30.9	30.5	30.5	30.0	30.0
Expenditures/GDP	36.0	34.1	33.9	34.4	33.0	33.7	33.2	33.5	32.5	32.5
Interest/revenues	2.8	3.1	3.3	3.8	3.8	4.4	4.3	4.7	5.4	6.4
Debt/GDP	33.7	35.7	40.7	41.6	44.2	44.3	47.2	47.9	48.5	48.8
Debt/revenues	105.1	118.8	137.2	134.3	145.7	143.3	154.9	157.2	161.6	162.7
Net debt/GDP	26.6	29.4	33.2	36.4	38.2	40.2	42.2	44.3	45.1	45.6
Liquid assets/GDP	7.1	6.3	7.5	5.2	6.0	4.0	5.1	3.6	3.4	3.2
MONETARY INDICATORS (%)										
CPI growth	3.3	2.8	(0.3)	(0.3)	(0.2)	1.4	1.7	2.2	2.5	2.5
GDP deflator growth	1.0	4.5	1.4	2.0	4.1	3.5	2.2	2.6	2.8	2.8
Exchange rate, year-end (MKD/$)	46.65	44.63	50.56	56.37	58.33	51.27	50.45	48.85	49.24	49.24
Banks' claims on resident non-gov't sector growth	5.2	6.3	9.9	9.5	1.1	5.7	5.0	6.0	6.0	6.0
Banks' claims on resident non-gov't sector/GDP	47.0	46.5	48.6	50.2	47.4	48.4	48.4	48.6	48.6	48.6
Foreign currency share of claims by banks on residents	51.4	47.9	44.9	42.5	42.1	40.5	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	46.8	43.9	41.0	41.2	41.6	40.9	N/A	N/A	N/A	N/A
Real effective exchange rate growth	0.1	1.6	1.0	(0.3)	1.1	(0.5)	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. MKD--Macedonian denar. 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

Macedonia Ratings Score Snapshot

Key rating factors	
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Table 2

Macedonia Ratings Score Snapshot (cont.)	
Key rating factors	
Monetary assessment	4

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). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score 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 scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings List, Sept. 5, 2018
- Sovereign Ratings History, Sept. 5, 2018
- Sovereign Ratings Score Snapshot, Sept. 4, 2018
- Global Sovereign Rating Trends Midyear 2018, July 16, 2018
- Sovereign Risk Indicators, July 5, 2018. A free interactive version is available at http://www.spratings.com/sri.
- Default, Transition, and Recovery: 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Sovereign Debt 2018: Global Borrowing To Remain Steady At US$7.4 Trillion, Feb. 22, 2018
- Central And Eastern Europe And CIS Sovereign Rating Trends 2018, Jan. 10, 2018

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's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

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 Affirmed

Macedonia	
Sovereign Credit Rating	BB-/Stable/B
Transfer & Convertibility Assessment	BB
Senior Unsecured	BB-

Additional Contact:
EMEA Sovereign and IPF; SovereignIPF@spglobal.com

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website 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.