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Research Update:

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

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

Secondary Contact:
Sabine Daehn, Frankfurt (49) 69-33-999-244; sabine.daehn@spglobal.com

Research Contributor:
Nathalie Poignant, London +44 20 7176 8626; nathalie.poignant@spglobal.com

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Research Update:

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Overview

- Macedonia's institutional landscape remains weak and the long-lasting political crisis has continued in the aftermath of the December 2016 general election.
- We believe that comparatively low--albeit rising--general government debt still provides some fiscal policy flexibility.
- 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 debt and heightened political uncertainty over the next 12 months, and the country's favorable economic prospects.

Rating Action

On March 17, 2017, 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 levels; weak checks and balances between state institutions, exacerbated by the prolonged political crisis; 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.

Macedonia has been locked in a political crisis for the last two years. Following a very narrow win in the December 2016 early general election, VMRO-DPMNE failed to reach an agreement with its previous coalition partner Democratic Union for Integration (DUI), which represents the Albanian minority. Subsequently, the main opposition party SDSM has secured enough support from Albanian minority parties on the condition that Albanian language is recognized across the country. However, public protests against the proposal took place and president Gjorge Ivanov refused to grant SDSM a mandate to form a government.

We believe that the current political stalemate portends heightened uncertainty in the absence of a clear way out. In our view, Macedonia's weak institutional arrangements--characterized by the lack of effective checks and balances between government bodies and limited independence of the judiciary--hamper an effective resolution of the present impasse. Another early election remains a possibility but it is unclear whether it could lead to a conclusive outcome. Moreover, absent a grand coalition between VMRO-DPMNE and SDSM--which currently seems improbable--any future government is likely to have an only narrow majority. This will diminish its ability to pass reforms and tackle long-standing issues such as the ongoing dispute with Greece over Macedonia's constitutional name.

In our view, the protracted political crisis could pose risks to the country's economic performance. Although headline growth appears to have already been affected, it has not been too severe so far. We estimate that the Macedonian economy grew by 2.5% in 2016 on the back of strong private consumption and export performance. That said, we estimate that investment dynamics were considerably weaker than in 2014-2015.

We forecast headline growth will slow down further to 2% in 2017 before recuperating closer to 3% once the political uncertainties subside. However, there are downside risks to these forecasts. With GDP per capita estimated at just $5,200 in 2016, Macedonia remains a low income economy. In recent years, the government has attempted to attract foreign direct investment (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, persisting political uncertainty could weigh on growth if a substantial portion of these foreign investments are cancelled or postponed. So far, net FDI has held up well at around 4% of GDP last year.

Political risks aside, we believe there is upside potential for the economy's long-term growth prospects from the free zones expansion. 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.

Although Macedonia has been running persistent budget deficits, we believe its fiscal profile still leaves some space for policy flexibility, which supports the ratings. We estimate that the general government deficit amounted to 2.8% 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 ongoing political stalemate. At present, the government targets gradual consolidation with deficit declining to 2.2% of GDP by 2019. In our view, however, the consolidation plan lacks concrete measures and could fall short of target if growth or revenue collection underperform. Consequently, we forecast deficits averaging 3% of GDP over the next four years.

We also believe that while net general government debt remains comparatively low, it will continue to rise to 47% of GDP in 2020 from an estimated 39% of GDP at 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 35% of current account receipts. We forecast that Macedonia's external debt metrics will remain broadly stable over the next four years. Last year's current account deficit turned out to be wider than we projected, at 3.1% of GDP. This is largely explained by the weaker performance of current transfers and larger primary income deficit. Nevertheless, we anticipate the current account deficit will gradually tighten and reach 1.2% of GDP in 2020, partly owing to the positive impact from 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. This affords the National Bank of the Republic of Macedonia (NBRM) some room for policy response. Rather exceptionally for the region, bank lending in Macedonia has also continued to increase in recent years. That said, even though the overall stock of domestic credit expanded by an estimated 4% last year, lending to corporates contracted in year-on-year terms.

Macedonia's banking system has seen several bouts of volatility in recent years. For example, political developments caused deposit outflows from Macedonia's banking sector last April, 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 the end of 2016, nonperforming loans in the system amounted to about 7% of the total.

Outlook

The stable outlook reflects the balance between the risks from Macedonia's rising public debt and heightened 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 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 the ratings if the protracted political uncertainty substantially impaired growth and FDI inflows, 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 cut their exposure to subsidiaries, we could consider a negative rating action.

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	604	625	651	684	723
Nominal GDP (bil. $)	10	10	11	11	10	11	11	11	12	13
GDP per capita (000s $)	5.1	4.7	5.2	5.5	4.9	5.2	5.2	5.5	5.9	6.2
Real GDP growth	2.3	(0.5)	2.9	3.6	3.8	2.5	2.0	2.7	2.8	3.0
Real GDP per capita growth	2.1	(0.6)	2.8	3.5	3.7	2.4	1.9	2.6	2.7	2.9
Real investment growth	17.9	10.2	0.5	10.7	3.6	1.0	0.8	2.5	3.0	3.5
Investment/GDP	26.9	28.9	28.8	30.3	31.1	33.9	34.1	33.8	33.4	33.1
Savings/GDP	24.4	25.7	27.2	29.7	29.1	30.7	31.3	31.4	31.6	31.9
Exports/GDP	47.1	45.4	43.4	47.7	48.8	49.5	51.7	53.9	56.0	57.9
Real exports growth	16.1	2.0	6.1	16.5	6.7	10.2	6.0	6.0	6.0	6.0
Unemployment rate	31.4	31.0	29.0	28.0	26.1	23.4	23.0	22.5	22.0	21.5
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(2.5)	(3.3)	(1.6)	(0.6)	(2.0)	(3.1)	(2.8)	(2.4)	(1.8)	(1.2)
Current account balance/CARs	(3.6)	(4.8)	(2.5)	(0.9)	(2.9)	(4.6)	(4.0)	(3.3)	(2.4)	(1.6)
CARs/GDP	68.3	68.7	65.4	69.1	68.8	67.8	70.5	72.4	74.2	76.0
Trade balance/GDP	(25.2)	(26.5)	(22.9)	(21.7)	(20.1)	(19.0)	(19.0)	(18.7)	(18.1)	(17.6)
Net FDI/GDP	4.5	1.7	2.8	2.3	2.3	3.6	1.7	1.7	2.7	2.7
Net portfolio equity inflow/GDP	(0.4)	(0.2)	(0.4)	(0.4)	(0.4)	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)
Gross external financing needs/CARs plus usable reserves	114.9	117.6	114.2	111.9	111.7	113.6	112.9	113.7	115.2	115.4
Narrow net external debt/CARs	24.7	27.7	29.2	25.1	26.9	35.1	36.3	36.9	35.7	35.1
Net external liabilities/CARs	71.5	82.3	88.8	70.4	80.3	90.0	91.4	88.9	85.6	82.6

Table 1

Republic of Macedonia Selected Indicators (cont.)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Short-term external debt by remaining maturity/CARs	24.0	32.4	31.9	25.8	27.1	21.7	23.2	22.4	21.4	20.7
Reserves/CAPs (months)	1.3	1.9	2.1	1.6	1.9	1.3	1.5	1.2	0.9	0.7
Reserves (mil. $)*	1,113	1,253	1,034	1,137	825	960	881	682	587	573
FISCAL INDICATORS (%, General government)										
Balance/GDP	(2.6)	(3.9)	(4.0)	(4.2)	(3.4)	(2.8)	(3.0)	(3.5)	(3.5)	(3.0)
Change in debt/GDP	4.9	6.1	4.4	6.8	3.1	5.2	4.0	4.4	3.9	3.0
Primary balance/GDP	(1.8)	(3.0)	(3.1)	(3.2)	(2.3)	(1.6)	(1.7)	(2.1)	(2.1)	(1.5)
Revenue/GDP	31.7	32.1	30.1	29.7	31.0	30.2	29.5	29.5	29.5	29.5
Expenditures/GDP	34.2	36.0	34.1	33.9	34.4	33.0	32.5	33.0	33.0	32.5
Interest /revenues	2.4	2.8	3.1	3.3	3.8	3.8	4.4	4.7	4.9	5.0
Debt/GDP	27.7	33.7	35.7	40.7	41.6	43.7	46.2	48.8	50.4	50.7
Debt/Revenue	87.5	105.1	118.8	137.2	134.3	144.7	156.6	165.3	170.7	171.9
Net debt/GDP	22.9	26.6	29.4	33.2	36.4	38.9	41.5	44.3	46.1	46.7
Liquid assets/GDP	4.9	7.1	6.3	7.5	5.2	4.8	4.7	4.5	4.3	4.0
MONETARY INDICATORS (%)										
CPI growth	3.9	3.3	2.8	(0.3)	(0.3)	(0.3)	1.0	1.6	2.2	2.5
GDP deflator growth	3.7	1.0	4.5	1.4	1.9	5.5	1.5	1.5	2.2	2.5
Exchange rate, year-end (LC/$)	47.53	46.65	44.63	50.56	56.37	58.33	58.07	56.21	55.75	55.75
Banks' claims on resident non-gov't sector growth	8.4	5.2	6.3	9.9	9.5	4.0	4.0	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	48.3	48.6	48.9	49.4	49.5
Foreign currency share of claims by banks on residents**	56.0	51.4	47.9	44.9	42.5	40.9	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

*Gross central bank foreign currency reserves net of required bank reserves on resident foreign currency deposits and the U.S. dollar equivalent of the monetary base. **Claims here refer to lending to the private sector. 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	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

- Republic of Macedonia 'BB-/B' Ratings Affirmed; Outlook Stable, Sept. 30, 2016
- Sovereign Risk Indicators, Dec. 14, 2016. An interactive version is available at www.spratings.com/sri
- 2015 Annual Sovereign Defaults 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 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.