FitchRatings

FITCH AFFIRMS MACEDONIA AT 'BB+'; STABLE OUTLOOK

Fitch Ratings-London-18 October 2012: Fitch Ratings has affirmed Macedonia's Long-term foreign currency and local currency Issuer Default Ratings (IDRs) at 'BB+'. The Outlook is Stable. Fitch has simultaneously affirmed Macedonia's Short-term rating at 'B' and Country Ceiling at 'BBB-'.

The affirmation balances the country's track record of low inflation and moderate budget deficits, relatively low public debt level and well capitalised banking system against high unemployment, limited fiscal financing flexibility, and political risks.

GDP growth forecasts have been revised down through the course of the year, as Macedonia is an open economy and exports have been affected by recession in the eurozone, while domestic demand remains subdued. Nevertheless, Fitch expects full-year GDP growth at 0.5%, as multilateral credit lines boost domestic demand and help offset a contraction of 1.1% in H1. Increasing foreign direct investment (FDI) will allow growth to pick up to 2% and 3.5% in 2013 and 2014, respectively. FDI in sectors such as automotive holds the potential to reach the twin aims of reducing a large structural trade deficit and diversifying Macedonia's economy.

The official unemployment rate is high at 31% in H1, although it overstates the underlying position. Some FDI projects are labour intensive, which will help cut the unemployment rate somewhat in 2013-14.

The weak economy has adversely affected the performance of the budget and revealed some structural weaknesses in the public finances. In September 2012 the government disclosed budget arrears of 2% of GDP. It intends to clear these in two steps by Q113. This will raise the cash budget deficit target by one percentage point of GDP to 3.5% in 2012, above the previous target of 2.5%, and 3.5% in 2013. Fitch believes these revised targets are within reach, given Macedonia's strong fiscal track record, though the uncertain growth outlook represents a downside risk.

Fitch forecasts that general government debt will increase to 31.3% of GDP at end-2012, from 27.8% at end-2011, owing to weaker growth and slippage on the budget deficit. Nevertheless, this remains below the ten-year 'BB' range median of 40%.

This year the government has increased the share of debt issuance denominated in Macedonian denar (MKD), helping to deepen the local capital market. In 2012 domestic issuance, at both short- and medium-term maturities, was far larger than initially projected (an estimated EUR280m against EUR60m). Larger and more liquid domestic markets will increase the sovereign's financing flexibility.

Macedonia decided not to issue a Eurobond this year as originally indicated. Instead it has secured commercial bank loans and is planning to obtain a World Bank guaranteed loan, which should allow it to meet maturing external obligations in 2013 and into early 2014. Improvements in the transparency of its debt management strategy could help to increase confidence in its financing flexibility.

Overall, the macroeconomic and financial supervision frameworks are rating strengths. The MKD's peg to the euro is backed by adequate foreign-exchange reserves (FXR). The banking system's Tier-1 capital adequacy ratio (CAR) was over 14% in Q212. Non-performing loans (NPLs) have risen modestly but remain below 10% of total loans and are fully provisioned against. Euroisation has fallen, as confidence in the MKD increased amid the eurozone debt crisis.

Fitch expects the current account deficit (CAD) to come in around 2%-2.5% of GDP in 2012. CADs in 2013-14 are forecast at similar levels as in 2012. The large trade deficit will be covered mostly by private transfers, as has been the case in recent years. In January-July net private transfer

inflows increased by 30% y/y in EUR terms, an indication of increased confidence in the MKD. At an estimated 19% of GDP in 2012, net external debt is higher than the 10-year 'BB' median, although a large share is comprised of intercompany debt.

Political risks remain a material constraint on Macedonia's sovereign ratings. EU accession remains a distant prospect, despite the progress in several areas noted in the European Commission's annual Progress Report. No significant progress was achieved over the past 12 months in the "name dispute" with Greece, which will continue to block Macedonia's entry to NATO and further progress in the EU accession process. The government's commitment towards EU integration could weaken the longer the dispute continues, possibly damaging relations between the ethnic Macedonian majority and the ethnic Albanian minority.

In terms of triggers for possible rating actions, a material overshoot of the 2012-13 budget deficit targets, along with the failure to present a plan to prevent the re-occurrence of fiscal arrears could lead to a negative rating action. Worse than expected growth outturns in the EU, Macedonia's main trade partner, or major spillovers from potential increased turmoil in Greece would also be rating negative.

Conversely, increasing evidence that productive FDI is leading to the successful diversification of Macedonia's economic structure, in tandem with a recovery in the growth rate could put upward pressure on the rating over the medium-term.

Resolution of the name dispute would allow the formal opening of EU accession negotiations and could support a positive rating action, if other economic trends were favourable. Conversely, a material rise in ethnic tensions or other adverse political shocks could lead to a negative rating action.

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Applicable criteria, 'Sovereign Rating Methodology', dated 13 August 2012, are available at www.fitchratings.com

Applicable Criteria and Related Research:

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