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FYR of Macedonia

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SOVEREIGN RATING	Initial rating 14.09.2015	Review 17.03.2016	Monitoring 14.04.2016	Review 14.09.2016
Long-term rating:	BB- (ns)	BB- (ns)	BB- (ns)	BB- (ns)
Outlook:	Stable	Stable	Negative	Negative
Short-term rating:	B (ns)	B (ns)	B (ns)	B (ns)

● (ns) – not solicited rating

***BCRA – CREDIT RATING AGENCY AD (BCRA)** is the third fully recognized rating agency in the EU, registered pursuant to Regulation No. 1060/2009 of the European Parliament and of the Council. The credit ratings, assigned by the BCRA are valid throughout the EU and are fully equal to those, of the other agencies, recognized by the European Securities and Markets Authorities, without any territorial or other limitations.*

"BCRA - CREDIT RATING AGENCY" AD affirms the credit rating of the FYR of Macedonia with unsolicited sovereign long-term rating BB- (ns) and short-term B (ns) with negative outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied (http://www.bcra-bg.com/files/file_330.pdf).

The report has been prepared and the rating – assigned, based on public information, made available by the National Bank of the Republic of Macedonia, the State Statistical Office, the Ministry of Finance, the World Bank, the International Monetary Fund, the European Commission, BCRA's database etc. BCRA uses sources of information, which it considers reliable, however it cannot guarantee the accuracy, adequacy and completeness of the information used.

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The public witnessed two consecutive dates for early elections that failed to bring forth results – 24 April being the initial date, and 5 June being the second. Currently, the country is led by a technical government, consisting of both VMRO-DPMNE and SDSM representatives, with the sole purpose of preparing the ground for the early elections in December 2016.

Along with the failure of the first early elections in April 2016, the opposition required several conditions to be met if the party were to participate in future elections. One regarded the registration of disputed voters, and the other concerned the formation of an independent media body, which has to supervise the media presentation of the election process.

As the end of August neared both criteria were cleared, with some difficulties in choosing the last media body representative.

On the 31st August 2016 the four main political parties in Macedonia met and reached a consensus of holding the elections on 11 December. At the meeting VMRO-DPMNE declared that it would accept all conditions stated by the opposition thus providing no way of eluding the set date for holding the early elections.

The whole political development has left its mark on the economy, which registered an annual growth deceleration to a rate of 2.0-2.2% in real terms for H1 2016. The exports and domestic demand continue to contribute positively to the growth, but investments have decline considerably in Q1 2016.

The deficit in the Goods and Services category in the Balance of payments widens for the first five months of 2016 compared to 2015. Despite the political turmoil, foreign investors continue to be active in 2016, mostly due to the better performance of export-oriented production, preferential treatment of free economic trade zones and presence of foreign capital in such organizations and firms.

The reserve assets held by the National Bank of Republic of Macedonia (NBRM), however, decrease during 2015 and continue further down in 2016, driven by stronger demand for foreign currency and decreased confidence in domestic currency by residents fanned by ongoing political uncertainty. The process of de-denarization required the NBRM to intervene in the money markets and foreign exchange markets to counter the negative developments in local currency. This intervention led to a decrease in the bank's foreign assets. The processes also induced some changes in base interest rates, such as the MKDONIA, which increased in April and May due to higher liquidity demand by banks.

Public finance indicators also raise some critical comments. The government budget has undergone several revisions during 2016, with the last one being done in end-August connected to possible financial support to the flood-affected areas.

Slower economic growth during the current year implies lower corporate profit and consumption directly affecting Profit tax and VAT revenues leading to lower performance on the revenue side of the state budget than initially intended. Although the expenditures (mainly capital expenditures) are also projected to decrease, the MoF expects further growth in the budget deficit with the imbalance reaching 4.0% of GDP for 2016. This will further contribute to the gradual increase of the country's indebtedness, keeping in mind the reluctance of changing tax rates in an upward direction.

The correction in the budget in July also foresaw the issuance of Eurobonds with a scope of EUR 450 M. The coupon rate has reached 5.625% for 7-year Eurobonds which is considerably higher than the rate of the same instruments issued in the middle of 2014 (3.975%). These numbers affirm the greater risk and related uncertainty of current and future economic and political developments perceived by foreign investors as well as the costly international financing of budgetary imbalances, keeping in mind the low and even negative rates on some financial products in the EU and ECB. General government interest payments have grown almost twice for the last 5 years and will probably continue growing in 2016, judging by the revised central government budget.

After the Eurobond issuance, in order to bring down net public debt, the MoF has decided to decrease the number of government securities auctions, thus it will not carry out all auctions listed on the MoF calendar for the current year.

Public debt has been growing steadily in the last 5 years, reaching 46.5% of GDP in 2015. Judging from recent events, it may even surpass 50% of GDP in end-2016 (standing at 50-51% of GDP in August) despite the slight concentration in government security payments at year's end. Although still under 60% of GDP, the steady increase in public debt (especially external debt) raises concerns about the government's debt management strategy sustainability and its abilities to answer to adverse developments in the economy and, thereof, deteriorations in state budget.

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Gross external debt has been growing throughout the past year, keeping its upward movement in 2016 and reaching 70.9% of GDP in March. General government holds a considerable share – of about 1/3 of total gross debt, mostly in the form of received long-term loans and issued debt securities.

Private debt also increases in the last year, though not as fast as public debt, including intercompany lending, implying an overall increase in the economy's indebtedness.

The price level keeps moving further into negative territory, driven by decreasing food and energy prices. The former is attributable to falling prices of bread, meat, dairy products and vegetables since March 2016 (on average annual basis), while the latter is fostered by the still prevailing low prices of oil and fuels, additionally incorporated into transport prices and heating costs. Although the annual core inflation (excludes food and oil prices in its scope) in Macedonia marks positive values in mid-2016, the NBRM considers that end-2016 inflation will be below projected levels of 0.5%.

Positive developments are visible on the labour market. Some rigidities have been countered and partially overcome in the past year. The unemployment rate has decreased to 24.0% for Q2 2016.

During the past year the initiative "Macedonia employs" had a major contribution to the observed development, said to has helped for the creation of nearly 16 000 jobs. It assures easier and preferential employment for certain groups of people that would otherwise have difficulties in finding a job. The project is carried out through partnerships with domestic firms and foreign investors which are exempt from social security tax under certain conditions. A second phase of the programme is in action, going under the name "Macedonia Employs 2".

The unemployment rate, however, remains at alarmingly high levels, much higher than representative EU-members, thus implying the presence of serious problems and obstacles standing before the economy that would take time until unemployment can reach publically comfortable levels.

The wages in the economy record an increase for 2015 on average and continue upwards during 2016. Real income of the population also increases on basis of falling prices (deflation) and growing nominal wages. The GDP per capita of the economy remains at the bottom relative to EU-members but marks stable growth rates in the last few years.

In the past half year the banking system underwent some changes and was put to the test by some adverse developments, but managed to counter them accordingly. As mentioned above, the prolonged political uncertainty lead to a switch from domestic currency to foreign currency in April 2016 and that, along with increased currency in circulation, entitled some liquidity problems for corporate banks. The NBRM acted swiftly and extended the necessary help by providing liquidity. Further measures were taken, such as the increased interest rate on CB bills to 4.0%.

Another change includes the increase in the reserve requirement ratio on banks' liabilities (deposits) in domestic currency with FX clause made at the beginning of May and entering into force as of 15 June 2016 – from 20% to 50% aiming at facilitating back denarization in the economy. Those liabilities hold little shares in total liabilities so, although considerable, the change did not lead to any serious inconveniences for corporate banks. In June the markets for foreign currency stabilized, according to a NBRM press-release, and banks registered net purchase of foreign currency.

Despite the dynamic economic and political environment, the banking system remains stable in Q2 2016, with high levels of capital adequacy and satisfactory liquidity. The sector grows steadily, provided with growing asset and deposit base as well as increase in credit activity (on an annual basis).

The share of non-performing loans in gross loans decreases considerably in Q2 2016 due to some regulatory changes – the NBRM has required banks to write off all claims within the period January-June 2016 which are "*fully provisioned for more than two years, in which the bank determined and fully covered the credit risk of non-collection at least two years before*", although they could still pursue their collection after writing them off. This also led to a slight contraction in gross loans on a quarterly basis, but has ensured banks' better performance in time.

Banks' profitability has been increasing steadily, supported by positive developments in the sector's financial result – it keeps an upward trend for the past 5 years and continues in the same direction in H1 2016.

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Outlook:

The negative outlook of the Sovereign Rating of the FYR of Macedonia reflects the BCRA's opinion that the political situation still carries some uncertainty until the early elections and formation of a stable government. Other factors that affected the decision of keeping the outlook include the transmission of negative effects from the political to the real, fiscal and monetary sectors and their possible worsening in time, as those effects find outlet. All listed developments are considered to have unfavourable effects on the country's general economic indicators and its creditworthiness.

BCRA would consider upgrading the Sovereign Rating and/or improving the rating Outlook for the FYR of Macedonia if further stabilization in the political situation is fostered through the formation of a functioning government. Additional positive effects would be considered the gradual correction in economic imbalances induced by the prolonged political instability and the clearance of negative effects in the real, fiscal and monetary sector, namely – reduction in budget deficit and sovereign indebtedness, improvement in balance of payments categories and restoration of the Central Bank's foreign reserve holdings.

BCRA would consider downgrading the Sovereign Rating for the FYR of Macedonia if there are adverse and/or unpredictable developments in the political sector, leading to increase in instability and uncertainty, as well as further deterioration in budgetary categories, increasing indebtedness, further deceleration in economic activity and investments as well as negative shocks to the banking system.

Regulatory announcements

Rating initiative

This is an unsolicited sovereign rating. Neither the rated entity, nor a related third party has participated in the credit rating process. BCRA did not have access to the accounts, management and other relevant internal documents for the rated entity or a related third party.

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Summary of the minutes of the Rating Committee:

The members of the Rating Committee evaluated a number of rating factors in accordance with the ***Sovereign Rating Methodology***.

The members commented on the still palpable uncertainty in the political sector despite the reached agreement on a date for the early elections. Stress was put on the transmission of negative effects from political events to the country's economic development and their manifestation in basic economic indicators. Notes were made on the unfavourable developments in public indicators, visible in the considerable growth in budget deficit as well as increased public debt. Positive comments were made regarding the labour market. Attention was given to the dynamics in the banking sector fanned by speculation resulting from political instability and uncertainty. Considering the measures undertaken by the Central bank to answer to adverse developments in foreign exchange markets and the data available at the time of this report, the banking sector was deemed stable.

The assigned sovereign rating and the related outlook have been determined based on the above discussion.

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Country	*Development classification*	*Probability of default indicator*
The FYR of Macedonia	*Emerging and Developing Europe* *(IMF classification)*	*CDS Market Indicator* *Not available.*

Basic economic indicators

	2016	2015	2015	2014	2013	2012	2011
	Q1	Q1					
GDP (current prices; in billion EUR) [1]	**2.293**	**2.114**	**9.093**	**8.533**	**8.148**	**7.589**	**7.548**
real annual growth rate (%)	2.0	3.8	3.7	3.5	2.9	-0.5	2.3
Final consumption	1.858	1.799	7.676	7.409	7.272	7.022	6.946
Household final consumption, including NPISHs	*1.475*	*1.432*	*6.157*	*5.970*	*5.846*	*5.607*	*5.579*
General government final consumption	*0.384*	*0.367*	*1.519*	*1.439*	*1.426*	*1.415*	*1.368*
Gross capital formation	0.727	0.636	2.898	2.599	2.347	2.195	2.031
Export of goods and services	1.106	0.984	4.413	4.083	3.536	3.443	3.557
Import of goods and services	1.399	1.304	5.893	5.557	5.008	5.072	4.987
GDP per capita (EUR) [2]	-	-	4,375	4,111	3,931	3,667	3,654
Unemployment rate (in %, population aged 15+)	24.5	27.3	26.1	28.0	29.0	31.0	31.4
	Q2	Q2					
Inflation - CPI (average, on cumulative basis, in %)	-0.4	-0.3	-0.3	-0.3	2.8	3.3	3.9
Total average monthly net wage (EUR)	359.22	352.04	355.58	347.30	343.28	339.88	338.99
Average exchange rate MKD/EUR	61.69	61.63	61.60	61.60	61.60	61.50	61.50
Average exchange rate MKD/USD	54.66	55.71	55.50	46.40	46.40	47.90	44.20

Balance of payments

	2016	2015	2015	2014	2013	2012	2011
in million EUR	I-V	I-V					
I. Current account	**-167**	**-132**	**-127**	**-69**	**-134**	**-240**	**-189**
Goods and services	***-599***	***-595***	***-1,483***	***-1,497***	***-1,488***	***-1,698***	***-1,546***
Primary income	***-100***	***-92***	***-222***	***-161***	***-193***	***-164***	***-131***
Secondary income	***532***	***555***	***1,577***	***1,589***	***1,547***	***1,622***	***1,487***

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II. Capital account		**5**	**2**	**6**	**3**	**15**	**9**	**-2**
III. Financial account		**-181**	**-109**	**-94**	**-33**	**-107**	**-212**	**-179**
Reserve assets		***-94***	***-187***	***-183***	***409***	***-44***	***142***	***331***
Government indicators								
	in billion EUR	**2016**	**2015**	**2015**	**2014**	**2013**	**2012**	**2011**
		I-VII	**I-VII**					
Central government budget	Revenues	1.573	1.503	2.617	2.369	2.277	2.246	2.230
	Expenditures	1.718	1.684	2.932	2.728	2.589	2.534	2.417
	Budget balance	-0.145	-0.180	-0.315	-0.359	-0.313	-0.288	-0.187
General government budget	Revenues	-	-	2.617	2.368	2.277	2.245	2.229
	Expenditures	-	-	2.932	2.727	2.590	2.533	2.416
	Budget balance	-	-	-0.315	-0.359	-0.313	-0.288	-0.187
	Surplus | Deficit (as % of GDP)	-	-	-3.5	-4.2	-3.8	-3.8	-2.5
		Q2	**Q2**					
General government debt	General government debt	3.486	3.239	3.453	3.263	2.772	2.555	2.093
	General government debt (as % of GDP), of which:	36.9	36.1	38.0	38.2	34.0	33.7	27.7
	External debt (% of GDP)	22.3	21.8	23.1	24.5	19.6	21.3	20.9
	Domestic debt (% of GDP)	14.6	14.3	14.9	13.7	14.4	12.4	6.8
	Guaranteed debt (% of GDP) [3]	8.3	7.6	8.6	7.7	6.3	4.7	4.3
		Q1	**Q1**					
Gross external debt		**6.707**	**6.245**	**6.354**	**5.992**	**5.220**	**5.172**	**4.847**
as % of GDP		*70.9*	*69.7*	*69.9*	*70.3*	*64.1*	*68.2*	*64.2*
Gross foreign reserves (stock, end of period)		**2.266**	**2.355**	**2.262**	**2.437**	**1.993**	**2.193**	**2.069**
Net International Investment Position		**-5.003**	**-4.612**	**-4.945**	**-4.549**	**-4.558**	**-4.178**	**-3.966**
Banking sector indicators								
		2016 Q2	**2015 Q2**	**2015**	**2014**	**2013**	**2012**	**2011**
	Ratios							
Capital adequacy ratio (%)		15.6	16.2	15.5	15.7	16.8	17.1	16.8
Liquid assets/ Total assets (%)		26.0	27.9	28.2	29.8	31.2	32.4	31.2
Highly liquid assets/ Total assets (%)		22.8	23.6	24.3	25.5	27.3	29.4	25.3

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Non-performing loans/ Total loans (%) (total loans to non-financial sector)	7.5	11.5	10.8	11.3	11.5	10.5	9.9
in bln. MKD							
Total (gross) loans (to nonfinancial entities)	272.9	262.6	277.5	253.0	230.1	216.2	202.4
in bln. EUR	*4.4*	*4.3*	*4.5*	*4.1*	*3.7*	*3.5*	*3.3*
Total deposits (of nonfinancial entities)	295.8	290.7	306.2	287.0	259.3	245.4	234.2
in bln. EUR	*4.8*	*4.7*	*5.0*	*4.7*	*4.2*	*4.0*	*3.8*
Total assets	416.5	403.5	423.7	400.3	369.5	352.9	331.2
in bln. EUR	*6.8*	*6.5*	*6.9*	*6.5*	*6.0*	*5.7*	*5.4*
Financial result (net profit/ loss) in mln. MKD	2,857.0	2,050.8	4,639.5	3,149.0	2,310.6	1,461.4	1,183.5
in mln. EUR	*46.3*	*33.3*	*75.3*	*51.1*	*37.5*	*23.8*	*19.2*

[1] Estimates for 2015 and 2016 (GDP value and its components).

[2] The value is calculated by using the indicator GDP per capita in LCU in current prices (World Bank Database) converted in EUR by using the average exchange rate MKD/EUR for corresponding period.

[3] Guaranteed debt of public enterprises and state owned joint stock companies.

Sources: National Bank of Republic of Macedonia, State Statistical Office, Ministry of Finance, World Bank, Eurostat, International Monetary Fund