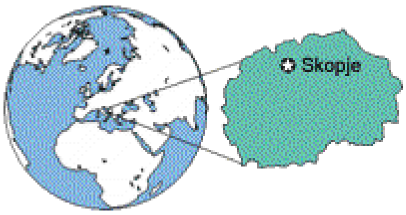
COUNTRY REVIEW

Macedonia, FYR



7 February 2011

ANALYST: Dr. Manfred Stamer

EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D

where AA is the lowest and D the highest risk.

Strengths

- Fairly good relations with the EU (except Greece) and international financial institutions
- Solid monetary policy
- Prudent fiscal policy

Weaknesses

- Underlying ethnic tensions
- Slow economic reform progress
- Unfavourable economic structure
- Persistently large trade deficits (around 20% of GDP)
- External debt burden is increasing rapidly
- FX reserves broadly stagnating since 2008 and meanwhile insufficient to cover all external debt payments due within one year
- Weak protection of property rights
- Very high unemployment

Country Risk Assessment

Ratings	Macedonia		Median	Peers		
	Latest	Previous	Grade D	Bosnia-H.	Belarus	Ukraine
Systemic Political Risk:	**P3+**	**P3+**	**P3+**	**P3-**	**P4**	**P3-**
Systemic Economic Risk:	**E6**	**E6**	**E6**	**E6**	**E6**	**E6**
ME rating:	ME6	ME6	ME6	ME6	ME6	ME6
Structure	*4.0*	*6.0*	*6.0*	*6.0*	*5.7*	*5.0*
Policy	*4.6*	*4.8*	*5.6*	*5.6*	*6.0*	*6.0*
Solvency	*6.0*	*3.6*	*4.3*	*3.9*	*4.9*	*6.0*
External Liquidity	*6.0*	*3.8*	*4.8*	*6.0*	*6.0*	*6.0*
SBE rating:	SBE4	SBE4	SBE5	SBE6	SBE5	SBE5
COUNTRY GRADE:	**D**	**D**		**D**	**D**	**D**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Skopje
Population:	2.061 mn (2009)
GDP:	USD 9276 mn (2009)
Currency:	Macedonian denar (MKD)
Form of state:	Parliamentary democracy
Head of government:	Prime Minister Nikola GRUEVSKI (since August 2006)
Next elections:	Legislative: 2012 / Presidential: 2014

Major Industries (% of GVA at market prices, 2009)	
Services	61.4%
Transport, storage & communication	9.0%
Industry	27.5%
Construction	5.9%
Agriculture	11.2%

Global Assumptions	2010	2011
Real GDP grth (% yr/yr)	3.3	2.9
Inflation (%, av) *	1.2	1.4
Dated brent (USD/b)	80	110

* Major economies

Main Exports (% of total, Jan-Nov 2010)	
Chemical products	10.9%
Food products	10.1%
Mineral fuels, lubricants & related ma	8.1%
Crude materials, except fuels	8.0%
Beverages & tobacco	6.1%

Main Imports (% of total, Jan-Nov 2010)	
Machinery & transport equipment	20.2%
Mineral fuels, lubricants & related ma	17.3%
Chemical products	12.6%
Food products	10.2%
Crude materials, except fuels	5.3%

Lead Export Markets (%, Jan-Nov 2010)	
EU-27	61.4%
Germany	20.5%
Bulgaria	9.0%
Kosovo	13.6%
Serbia	8.1%

Lead Import Markets (%, Jan-Nov 2010)	
EU-27	53.4%
Germany	11.1%
Greece	8.6%
Russia	9.6%
Serbia	7.8%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	7,921	9,833	9,277	9,001	9,357
Population (mn)	2.05	2.06	2.06	2.07	2.07
GDP per capita (USD)	3,866	4,785	4,501	4,355	4,512
Real GDP growth (% yr/yr)	6.1	5.0	-0.9	0.7	2.7
Inflation (%, eop)	6.7	4.1	-1.6	3.0	3.0
Fiscal balance (% of GDP)	0.6	-0.9	-2.6	-2.5	-2.5
Current account balance (% of GDP)	-7.6	-12.4	-7.0	-7.0	-6.4
External debt/GDP (%)	52.5	47.6	59.3	66.8	68.3
External debt/Exports of goods & services (%)	98.8	93.9	155.1	167.9	178.4
Debt-service ratio (%)	9.6	9.1	12.8	12.6	12.5
Foreign exchange reserves (EUR mn)	1,399	1,360	1,366	1,457	1,500
Import cover (months)	4.3	3.1	4.2	3.7	3.7
Exchange rate assumption, MKD:USD (av)	44.73	41.87	44.10	46.48	47.31
Exchange rate assumption, MKD:EUR (av)	61.18	61.27	61.27	61.50	61.50
f: CRU central forecast					

Sources: National figures, IMF, Eurostat, European Commission, IHS Global Insight, Euler Hermes Economic Studi

Political Stability

After achieving independence from Yugoslavia in 1991, political stability in Macedonia was threatened by ethnic tensions between (Slavic-speaking) Macedonians and a large Albanian minority which accounts for about 25% of the total population. Tensions reached a climax in a short Albanian armed insurgency in 2001. The Ohrid peace agreement, an internationally-brokered deal, ended the conflict, regulating the inter-ethnic reconciliation and guaranteeing the state's unity. Since then the situation has remained broadly peaceful, supported by several NATO- and EU-led peacekeeping missions until 2005, but full implementation of the Ohrid agreement continues to be a challenge.

Parliamentary elections in 2002 resulted in a coalition government that served a full term. Largely peaceful general elections in July 2006 brought an orderly change of government, but a lasting deadlock over economic reforms and rights for the Albanian minority resulted in the dissolution of parliament in April 2008, underscoring that government ineffectiveness and underlying ethnic tensions continue to jeopardise systemic political stability and the business environment. The ruling centre-right VMRO-DPMNE of Prime Minister Gruevski claimed a landslide victory in the subsequent snap election in June 2008, gaining 49% of the vote and 63 out of 120 parliamentary seats. Policymaking will nevertheless be difficult as the Ohrid agreement requires that certain legislation can only be passed with the majority support of MPs from ethnic minorities. To alleviate this problem, PM Gruevski has included DUI, the largest Albanian party (13%, 18 seats), and some small parties in the government, even though fractious relations between the VMRO-DPMNE and the uncompromising DUI, which emerged from the former Albanian National Liberation Army UCK, have been a major constraint on policymaking in the past. In 2009, the VMRO-DPMNE consolidated power further thanks to victories in the presidential and local elections. However, social discontent related to very high unemployment, estimated at over 30%, remains a challenge.

International integration is at the core of foreign policy. A first success was WTO membership in 2002. But an ongoing name dispute with Greece—which argues that Macedonia's constitutional name implies a territorial claim to its northern province that has the same name—continues to delay EU and NATO integration. In 2008 Greece vetoed NATO membership for Macedonia, and in 2009 it blocked a decision on setting a date for opening EU accession talks with Macedonia, which has been a candidate country since 2005. This leaves the country vulnerable to potential regional instability in the West Balkans (e.g. Kosovo). On a positive note, Macedonia enjoys IMF and World Bank support. In January 2011, it was the first country to secure an unconditional Precautionary Credit Line (PCL) from the IMF, worth up to about EUR475mn over two years. The PCL is an instrument established last year that is available to Fund members with sound economic policies that do not have actual financing needs but face risks that could give rise to such needs, i.e. it is a crisis-prevention toolkit.

Economic Stability

Although the economic structure has improved to some extent in recent years, it is still weak and the economy remains among the less developed in Europe. The primary sector accounts for 11% of GDP and industry (including construction) for just 27.5%, reflecting a small industrial base. Roughly half of exports are shipped to other emerging or developing markets, 22% alone to Serbia and Kosovo, leading to high vulnerability to external shocks in these countries. Average annual real growth of GDP per capita was just 2.2% in 2000-2010. Due to the ethnic-Albanian insurgency, economic output shrank by 4.5% in 2001 and has only gradually recovered by an annual average of 3% since then, well below the growth recorded in peer countries in the Balkans.

Real GDP contracted by a moderate 0.9% in 2009 in the wake of the global economic crisis, but the rebound in the first three quarters of 2010 was also modest at an estimated 0.4% yr/yr. We expect full-year growth of about 0.7% in 2010 and 2.7% in 2011.

Monetary policy has been reasonably solid in recent years. The Macedonian denar (MKD) is *de facto* pegged to the euro at a rate of around 61.5 MKD/EUR, which has kept inflation in check for many years. Moreover, the real effective exchange rate has been relatively stable since 2000. Annual inflation accelerated to 3% at end-2010 and we expect it to remain around that level in 2011, though potentially further rising food and energy prices pose an upside risk to this forecast.

Fiscal policy has been prudent since 2003 and the fiscal deficit remained moderate at 2.6% of GDP in recession year 2009. The deficit targets of 2.5% of GDP in 2010 and 2011 appear appropriate in view of current economic conditions and are projected to be achieved approximately. Financing should not be a problem, especially as the IMF PCL provides a buffer if needed. Public debt accounts for a comparatively low 25% or so of GDP.

The external position continues to be a cause for concern. Annual trade deficits have been very high at 20-25% of GDP for many years. With the services account being roughly balanced and the income account small, much of the trade deficits have been balanced by net current transfers. Still, annual current account deficits were relatively high in 2007-2010, between 7% and 12.4% of GDP. Moreover, the coverage of the external deficit through net foreign direct investment inflows declined rapidly from 116% in 2007 to just 36% in 2009. We forecast the 2011 current account deficit to narrow only slightly from around 7% of GDP in 2010. Foreign exchange (FX) reserves reached a high of EUR1.55bn in September 2008 but have since remained below that level and stood at EUR1.46bn in November 2010. This is still sufficient to finance four months of imports but it covers only about 85% of short-term external debt and principal repayments due in 2011.

The external debt position is precarious. Gross external debt has increased from USD3.3bn (52% of GDP; 109% of exports) at end-2006 to USD5.5bn (61% of GDP; 188% of exports) in Q3 2010 and is forecast to rise further. The external debt-service ratio of some 14.5% in 2010 and forecast at 12.5% in 2011 appears manageable, though is has risen from just 8.1% in 2008.

Structural Business Environment

The Structural Business Environment is about average in our assessment overall. The government has made an effort to improve Macedonia's attractiveness for foreign investment over the past years. A 10% flat tax rate for both corporate and personal incomes was introduced and, on paper, the country has improved in terms of regulatory quality, business freedom, trade freedom and financial sector freedom. However, in practice many deficiencies continue to hamper doing business. Areas of particular weakness include government intervention in the economy, effective implementation of reform measures, the overstaffed bureaucracy, significant corruption and weak protection of property rights. Bankruptcy proceedings take an average 2.9 years (the same as the Eastern Europe average), cost 28% of the estate's value (regional average 13.4%), and the recovery rate is just 20.7% (regional average 32.6%). The very high unemployment rate of over 30% masks a substantial level of black market activities including the smuggling of drugs. Overall, the EU, IMF and World Bank continue to urge Macedonia to accelerate its structural reform process.

Macedonia's banking sector has been assessed as healthy overall by a recent IMF report from February 2011. The 2007 Banking Law improved the supervisory and regulatory framework of the sector, which accounts for 90% of the financial system by assets. The global economic crisis took its toll in the form of a reduction in profitability and a significant increase in nonperforming loans from 6.8% in 2008 to 10.4% in Q3 2010, but they are 93% covered by provisions. Moreover, the underlying soundness of the banking sector appears to be intact, based on high capital adequacy ratios, strong liquidity and low reliance on foreign financing. However, the banking system is highly euroised, with 56.2% of deposits and 58% of loans either in FX or linked to FX in Q3 2010, such that stability of the *de facto* euro peg is important for the system's health. An issue to be monitored is that two Greek-owned banks represent 26% of the banking sector's assets, with Stopanska Bank (owned by the National Bank of Greece, the largest commercial banking group in Greece) being the largest bank in Macedonia (23% of assets) and thus systemically important. The recent IMF report rates Stopanska Bank as healthy, with an above-average capital ratio, independence from parent funding, and non-appearance of deposit outflows.

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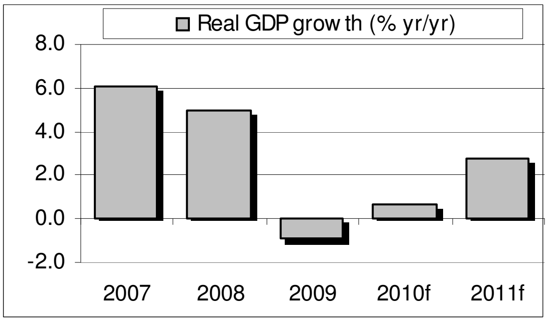
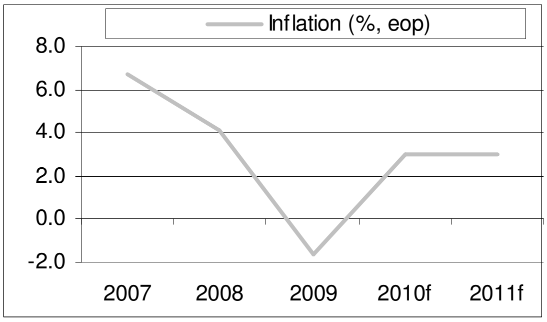
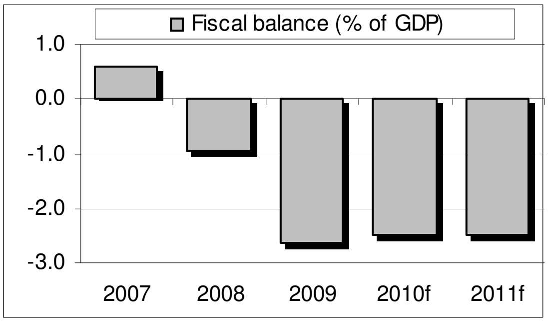
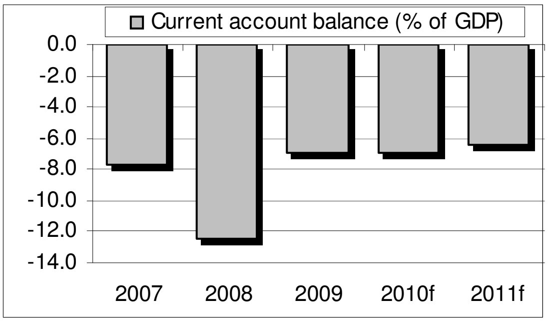
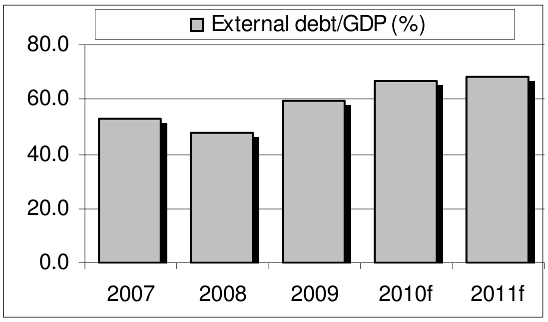
Charts

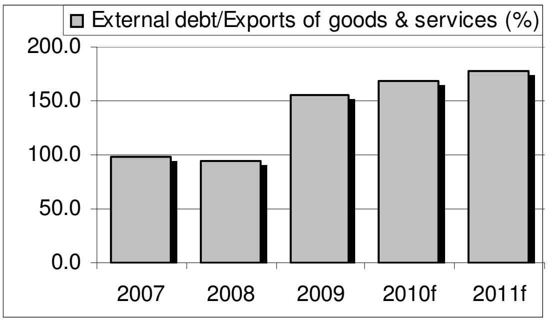

Real GDP growth (% yr/yr)
8.0
6.0
4.0
2.0
0.0
-2.0
2007
2008
2009
2010f
2011f

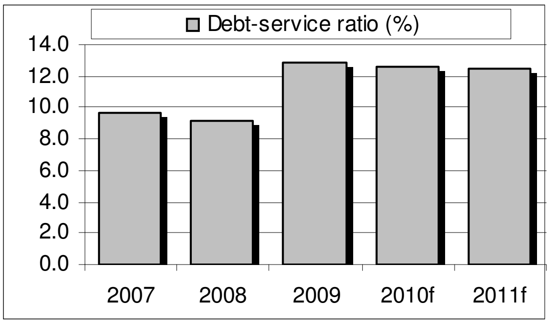

Inflation (%, eop)
8.0
6.0
4.0
2.0
0.0
-2.0
2007
2008
2009
2010f
2011f

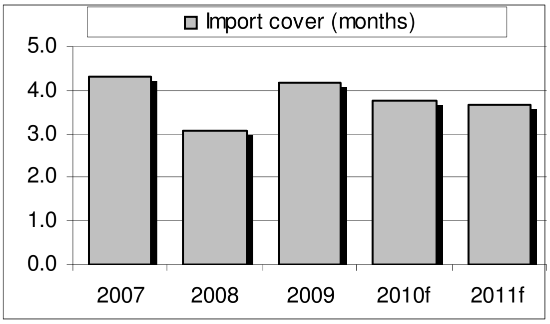

Fiscal balance (% of GDP)
1.0
0.0
-1.0
-2.0
-3.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
-12.0
-14.0
2007
2008
2009
2010f
2011f


External debt/GDP (%)
80.0
60.0
40.0
20.0
0.0
2007
2008
2009
2010f
2011f


External debt/Exports of goods & services (%)
200.0
150.0
100.0
50.0
0.0
2007
2008
2009
2010f
2011f


Debt-service ratio (%)
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f


Import cover (months)
5.0
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f