STANDARD & POOR'S

Global Credit Portal®
RatingsDirect®

August 24, 2011

Research Update:
Republic of Macedonia L-T LC Ratings Lowered To 'BB', FC Ratings Affirmed On Sovereign Criteria Change; Outlook Stable

Primary Credit Analyst:
Ana Mates, London (44) 20-7176-7109;ana_mates@standardandpoors.com

Secondary Contact:
Frank Gill, London (44) 20-7176-7129;frank_gill@standardandpoors.com

Table Of Contents

Research Update:

Republic of Macedonia L-T LC Ratings Lowered To 'BB', FC Ratings Affirmed On Sovereign Criteria Change; Outlook Stable

Overview

- Standard & Poor's has revised its methodology and assumptions for rating sovereign governments.
- As a result, we are lowering the long-term local currency sovereign credit rating on Macedonia to 'BB' from 'BB+' and affirming the long-term foreign currency sovereign credit rating at 'BB'.
- In our opinion, governments are likely to have fewer incentives to differentiate between their local and foreign currency debt in the event of a debt restructuring, given the increasing globalization of markets.
- The stable outlook reflects our view that Macedonia's creditworthiness could improve if it were to adequately address some of the structural issues that constrain growth rates, including a lack of infrastructure, unreliable energy provision, and high unemployment rates.

Rating Action

On Aug. 24, 2011, Standard & Poor's Ratings Services lowered its long-term local currency sovereign credit rating on the Republic of Macedonia to 'BB' from 'BB+' and affirmed its long-term foreign currency sovereign credit rating at 'BB'. We also affirmed the 'B' short-term ratings on Macedonia. The outlook is stable. Our transfer and convertibility assessment for Macedonia remains 'BB+'.

Rationale

The rating actions follow the implementation of Standard & Poor's revised methodology and assumptions for rating sovereign governments (see "Sovereign Government Rating Methodology And Assumptions," published June 30, 2011). Under our revised methodology, gaps between the local and foreign currency ratings on many of our rated sovereigns, if they exist, are narrowing. This is because we believe that governments are likely to have fewer incentives to differentiate between their local and foreign currency debt in the event of a debt restructuring, given the increasing globalization of markets.

Thus, in accordance with our criteria for rating sovereign governments, the local currency rating on Macedonia is equalized with the foreign currency rating. This partly reflects our view that a government has greater capacity to pay its local currency debt than its foreign currency debt, as long as it can manage its local currency independently. The pegged exchange rate regime prevents Macedonia from doing this as it is not able to set interest rates without regard to the currency's external value.

The ratings on Macedonia reflect our view of the sovereign's structural rigidities, inflexible government expenditure structure, and residual latent (albeit declining) risk of inter-ethnic tensions. The ratings are supported by the sovereign's moderate general government debt burden and EU accession prospects that anchor reforms.

We expect real GDP growth to reach 2.4% in 2011 and 3.1% in 2012, as Macedonia continues to recover from a relatively shallow recession (-0.9% in 2009). Weakening external demand from its main trading partners, including Germany, Serbia, and Greece, however, remains one of the key downside risks in the short term in our view. The government is working to address some of the structural issues that constrain trend growth rates, including the lack of infrastructure, unreliable energy provision, and high unemployment rates. If successfully implemented, these reforms could improve Macedonia's medium-term growth prospects and, with them, the ratings on the government.

Government debt increased to 25% of GDP in 2010 and we expect only small increases in the coming years as the government intends to run moderate deficits. We expect general government debt interest expenditure relative to revenues to remain relatively low, reflecting the still predominantly concessional terms on much of the debt. We expect that the general government deficits will decrease toward 1.8% of GDP by 2014 and that capital expenditure will progressively increase as a share of total spending starting in 2011. This shift in the government spending mix should be enabled by a continuation of the partial wage freeze and strict employment controls in the public sector and, if achieved, would enhance fiscal flexibility. In our view, fiscal flexibility is currently limited and restricts the government's room to maneuver to mitigate the impact of economic downturns and other shocks.

Macedonia's external debt levels are low. We estimate narrow net external debt (private and public sector nonequity external obligations minus reserves, public sector liquid external assets, and financial institutions' external assets) to be 19% of current account receipts (CARs) in 2011. The current account deficit contracted sharply to 3% of GDP in 2010. However, we do expect some deterioration in 2011. We expect that Macedonia's current account will continue to be largely financed by FDI and, therefore, external indebtedness is unlikely to grow as a percentage of CARs.

Macedonia was granted EU candidate status in 2005 and in April 2009 the European Commission recommended opening accession negotiations and moving to the second phase of implementing the Stabilization and Association Agreement (SAA). The prospects of EU accession have acted as a policy anchor for reforms to improve economic and political stability. Nevertheless, in our opinion the unresolved dispute with Greece about Macedonia's constitution remains an obstacle to EU and NATO accession, as Greece refuses to retract its veto. In our view, a quick resolution of the issue still appears unlikely, but this has not hampered the reform commitment.

The Ohrid Agreement (OFA) following the 2001 civil war has markedly improved minority rights and allowed for increased ethnic Albanian representation in public administration, particularly by strengthening the power of local governments. The OFA has broad political support among Macedonian citizens, and there is a general perception that both ethnic groups have ultimately benefited from it. No notable inter-ethnic tensions have been reported since the end of the 2001 civil war and we consider renewed ethnic conflict that could undermine political stability to be unlikely.

Outlook

The stable outlook reflects our view that Macedonia's creditworthiness could improve if it were to adequately address some of the structural issues which are currently constraining growth rates. These include a lack of infrastructure, unreliable energy provision, and high unemployment rates. Higher private sector investment is also likely to provide support to Macedonia's wealth levels and credit rating. Maturing political institutions with improving effectiveness, stability, and predictability of policy making would also over time support stronger creditworthiness.

We believe a renewed worsening of external liquidity indicators (due most likely to rising current account deficits that may in part be funded by drawing down of international reserves) would put downward pressure on the ratings. Additionally, a significant deterioration in the government's debt burden could also lead us to lower the credit rating on Macedonia.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Introduction Of Sovereign Recovery Ratings, June 14, 2007

Ratings List

Downgraded; Ratings Affirmed

	To	From
Macedonia (Republic of)		
Sovereign Credit Rating		
Local Currency	BB/Stable/B	BB+/Stable/B
Ratings Affirmed		
Sovereign Credit Rating		
Foreign Currency	BB/Stable/B	
Transfer & Convertibility Assessment		
Local Currency	BB+	

Downgraded

	To	From
Senior Unsecured	BB	BB+

Ratings Affirmed

Senior Unsecured	
EUR150 mil 4.625% bnds due 12/08/2015	BB
Recovery Rating	3
EUR175 mil 9.875% nts due 01/08/2013	BB
Recovery Rating	3

Additional Contact:
Financial Institutions Ratings Europe;FIG_Europe@standardandpoors.com

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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.