Commentary Report

Republic of Macedonia 'BB+' LT, 'B' ST FC Ratings Affirmed On Fiscal Prudence; Outlook Stable

Primary Credit Analysts:
Sladana Tepic
London
(44) 20-7176-7125
sladana_tepic@
standardandpoors.com

Secondary Credit Analyst: Kai
Stukenbrock
Frankfurt
(49) 69-33-999-247
kai_stukenbrock@
standardandpoors.com

Additional Contact: Sovereign
Ratings
SovereignLondon@
standardandpoors.com

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Rationale

On May 8, 2006, Standard & Poor's Ratings Services affirmed its 'BB+' long-term foreign currency and 'BBB-' long-term local currency sovereign credit ratings on the Republic of Macedonia. At the same time, the 'B' short-term foreign currency and 'A-3' short-term local currency ratings on Macedonia were affirmed. The outlook is stable.

The ratings on Macedonia are supported by its sustained improvement in political stability, stable economic growth, sound fiscal results and consequent decline in government debt, and significant progress on enacting legislation underpinning reforms and EU integration, in particular with regard to labor market reforms. The ratings are constrained by labor market challenges, limited fiscal flexibility, and residual political tensions.

The Macedonian government has successfully concluded its commitments under the Ohrid Framework Agreement that ended the 2001 security crisis, despite the often politically contentious legislation required to fulfill the terms of the Agreement. The political environment has matured as minority rights have been extended, and a repeat of the 2001 interethnic violence looks unlikely. In any case, the commitment of the international community to maintaining the current stability remains strong, and will have a moderating influence if tensions were to increase in the future. Furthermore, the EU membership candidacy status, granted in December 2005, opens the prospect for accession after 2010. The process of EU integration will remain an important policy anchor and driver for reforms.

In the medium term, we expect that the government's commitment to completing the reform of the social security sector and further improvement in the investment climate should keep the general government budget deficit at about 0.6% of GDP. Meanwhile, GDP growth is forecast at 4.0% in 2006 and 4.5% in the medium to long term, owing mainly to a recovery in the industrial and export sectors and to the improving investment climate. Moreover, ambitious reforms completed or ongoing will address structural rigidities and obstacles to economic growth.

Fiscal consolidation and stable economic growth are forecast to continue lowering the general government debt level, to 34% of GDP by 2009, from 41% in 2005. By contrast, structural rigidities on the expenditure side, as well as inefficient social security and health care systems, pose risks to the maintenance of fiscal prudence.

In addition to this expenditure inflexibility, the ratings are constrained by high unemployment and inflexible labor markets, a weak judicial system and administrative obstacles to foreign investment, and the latent (although declining) risk of interethnic tensions.

Outlook

The stable outlook reflects our expectation that the July 2006 parliamentary election will not jeopardize sustained and tangible progress in implementing structural reforms, and that macroeconomic stability and fiscal prudence will be maintained. Furthermore, the outlook is based on the assumption of a continued normalization of interethnic relations. Under this scenario, both the economic and the institutional frameworks would become more robust and resilient to adverse shocks, which could eventually lead to an upgrade of the foreign currency rating to investment grade. Conversely, the ratings could come under downward pressure if the determination and consensus to pursue and to implement important structural reforms and prudent macroeconomic policies were to recede, or if political stability and interethnic relations were called into question again.

Ratings List

Foreign currency sovereign credit ratings

BB+/Stable/B

Local currency sovereign credit ratings

BBB-/Stable/A-3

Foreign currency senior unsecured debt

BB+

Local currency senior unsecured debt

BBB-