

September 21, 2009

Research Update:

Republic of Macedonia's Outlook Revised To Stable From Negative On Improved External Liquidity; Ratings Affirmed

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Research

Ratings List

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Republic of Macedonia's Outlook Revised To Stable From Negative On Improved External Liquidity; Ratings Affirmed

Overview

- External pressures facing Macedonia have eased.
- The current account deficit is expected to decline to 8.5% of GDP this year, while the government's eurobond issue and multilateral funds have provided external financing.
- We are revising the outlook on the ratings to stable from negative.

Rating Action

On Sept. 21, 2009, Standard & Poor's Ratings Services revised its outlook on its sovereign credit ratings on the Republic of Macedonia to stable from negative. At the same time, we affirmed the 'BB/B' long- and short-term foreign currency and 'BB+/B' local currency ratings. The transfer and convertibility assessment on Macedonia was affirmed at 'BB+', and the recovery rating on Macedonia's foreign currency debt remains '3'.

Rationale

The outlook revision reflects our view that the external pressures facing Macedonia have eased, albeit not fully subsided. The narrowing of the large current account deficit now under way, plus the government's ability to have attracted external funds have allayed concerns over Macedonia's external liquidity and the sustainability of the exchange rate anchor.

The rapid deterioration of external demand and terms of trade, leading to a current account deficit of 12.7% of GDP in 2008, left the nation vulnerable to a sudden stop in external finance. An adjustment process is now under way, however, with an improving trade balance, as a result of which we expect the deficit to narrow to 8.5% of GDP in 2009. On the financing side, the government's issue of a €175 million (2.7% of GDP) eurobond in July, expected net FDI inflows of 3% of GDP, and multilateral lending have reduced pressure on international reserves, and therefore also on the exchange rate peg against the euro. As a result, we now expect the reserve coverage of imports to remain at about three months in 2009, but to potentially fall in 2010-2011.

We expect the difficult external environment to contribute to a contraction in economic activity by 2.5% in 2009, and to a weakening of the budget outturn. To redress the situation the government has submitted another supplementary budget to parliament in September, envisaging expenditure cuts in areas such as wages and salaries as well as capital expenditure. We expect deficits at 3% of GDP in 2009 and in the following years, which would push

Macedonia's moderate general government debt burden to 29% of GDP by 2012, from 21% in 2008 (compared with 39% of GDP in 2005).

Macedonia's aspirations to initiate membership negotiations with the EU remain overshadowed by the unresolved issue of Macedonia's constitutional name, to which Greece objects. The EU is expected to provide a positive assessment in its next progress report in October 2009. However, as long as the name issue remains unresolved, Greece will likely use its veto power to block Macedonia's entry into the EU, as it vetoed Macedonia's accession to NATO in April 2008.

Outlook

The outlook is stable. We believe a renewed worsening of external liquidity indicators (due most likely to falling levels of international reserves), would intensify the risk of a disorderly exit from the fixed exchange rate regime and would put downward pressure on the ratings on Macedonia. A resurgence of ethnic strife could also be detrimental to the ratings.

Conversely, a decisive and timely approach to tackling imbalances and reform needs, including increasing employment, enhancing productivity in the tradable sector, and deepening financial markets that enabled Macedonia to rely less on external savings, would contribute positively to Macedonia's creditworthiness. Further support could come from reforms of social security systems or the energy sector, which could eventually contribute to a return to dynamic and balanced growth after the current slowdown.

Related Research

- Sovereign Credit Ratings: A Primer, May 29, 2008.
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009.
- Introduction Of Sovereign Recovery Ratings, June 14, 2007.

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Macedonia (Republic of)		
Sovereign Credit Rating		
Foreign Currency	BB/Stable/B	BB/Negative/B
Local Currency	BB+/Stable/B	BB+/Negative/B

Unchanged

Transfer & Convertibility Assessment	BB+
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Ratings Affirmed

Senior Unsecured	
Foreign Currency	BB
Recovery Rating	3

Senior Unsecured
Local Currency

BB+

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