S&P Global
Ratings

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Summary:
North Macedonia

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Summary:

North Macedonia

Issuer Credit Rating	BB-/Stable/B

Key Rating Factors

Institutional and economic profile	Flexibility and performance profile
Modest per capita income levels but there is upside reform potential, including from the likely start of EU accession negotiations later this year. • North Macedonia is likely to start EU accession talks later this year, following the earlier resolution of a name dispute with Greece, although uncertainties remain. • In our view, reform momentum could subsequently accelerate, but progress would most likely be gradual. • We forecast economic growth will average 3% through 2022, provided there is no major slowdown in North Macedonia's key European trading partners.	The North Macedonian denar's peg to the euro dictates monetary policy but moderate public debt level still leaves some room to manuever. • At slightly above 40% of GDP, North Macedonia's net general government debt remains moderate in a global context, but there has been an erosion of fiscal space in recent years. • After a temporary widening to 2.3% of GDP in 2019, the current account deficits are likely to moderate towards 1.5% of GDP in the medium term as export capacities in free economic zones gradually build up. • North Macedonia's monetary flexibility is higher than that of most other Balkan states, but the denar's peg to the euro constrains the central bank's policies.

Outlook

The stable outlook reflects the balance between the risks from North Macedonia's rising public debt and still comparatively modest income levels, and its favorable economic prospects alongside the potential for institutional settings to strengthen over time.

We could raise our ratings on North Macedonia if timely reform implementation, for instance as part of EU accession negotiations, strengthened North Macedonia's institutional arrangements and improved its economic prospects. We could also consider an upgrade if North Macedonia displayed a stronger fiscal performance that placed net general government debt firmly on a downward path.

We could lower the ratings if major political tensions returned or reform momentum waned, impairing growth and foreign direct investment (FDI) and undermining the country's longer-term growth prospects. We could also lower the ratings if large fiscal slippages or off-budget activities were to call into question the sustainability of North Macedonia's public debt, raise the sovereign's borrowing costs, and substantially increase its external obligations, given the constraints of the exchange-rate regime.

Rationale

The ratings on North Macedonia reflect our view of the country's relatively low income levels; still comparatively weak institutional settings despite some recent improvements; and limited monetary policy flexibility arising from the country's fixed exchange-rate regime. The ratings are primarily supported by moderate--albeit rising--external and public debt levels and favorable growth potential.

Institutional and economic profile: EU accession talks likely to start in the coming months

In January 2019, a long-standing dispute between Greece and North Macedonia over the latter's name was finally resolved. The disagreement had stemmed from Greece's objection to North Macedonia calling itself Republic of Macedonia because there is a similarly named region in Greece. Under the solution unveiled for the first time in June 2018 (the Prespa agreement), the country's name has changed to Republic of North Macedonia. After decades of gridlock, it took less than a year to agree and implement the newfound solution. It was ratified in both countries' parliaments and entered into force in February.

The resolution of the name dispute is an important positive milestone that we expect will reduce North Macedonia's past isolation and contribute to regional stability. More specifically, the agreement paves the way for North Macedonia's NATO membership as well as EU accession negotiations. Although North Macedonia has been an EU candidate since 2005, Greece has previously blocked progress on membership talks.

Our baseline forecast is that formal EU accession talks will begin in the coming months. The earlier expectation of some observers that European Council will approve the start of negotiations already in June did not materialize. Back then the Council announced its intention to reach a substantive decision no later than October 2019.

Several hurdles could still stand in the way of opening negotiations, including enlargement fatigue in several EU member states, the rise of nationalism as well as potential concerns over corruption and the rule of law in North Macedonia. In the past, senior government officials from various EU member states including the Netherlands and France publicly expressed their reservations about EU enlargement. Nevertheless, we consider that EU will likely recognize the substantial progress achieved by North Macedonia in resolving the name dispute, opening membership talks later this year.

In our view, EU membership negotiations could accelerate reform momentum and improve institutional capacity as North Macedonia implements changes required to align it with Acquis Communautaire, the body of EU law. Nevertheless, we consider that it will take time before any adopted reforms bear full fruit and become firmly entrenched within the institutional framework. We do not expect North Macedonia to join the EU in the short-to-medium term, based primarily on the experience of other countries in the region in recent years. For example, Montenegro and Serbia started accession negotiations in 2012 and 2014, respectively. The European Commission last year stated that they could join the EU by 2025 provided that required reforms are implemented. Assuming a similar timeframe, North Macedonia is unlikely to join the EU before 2030, in our view.

Beyond the resolution of the name dispute, domestic political stability has notably improved over the last two years. The government centered around the Social Democratic Union of Macedonia (SDSM) came to power in May 2017 ending a period of prolonged political uncertainty. It has governed ever since and has progressively strengthened its majority in Parliament mostly through cooperation with several smaller ethnic Albanian parties. We consider this an important positive development which represents an orderly power transfer after more than 10 years of VMRO-DPMNE party rule. More recently, SDSM candidate Stevo Pendarovski won the second round of presidential elections in May. This should improve governance effectiveness given that the previos president Gjorge Ivanov was aligned with the VMRO party and on several occassions refused to sign legislation promoted by SDSM.

That said, several domestic political risks remain. Over the last few weeks, the so-called "extortion" case came to public attention and subsequently a court put North Macedonia's chief special prosecutor in detention over potential abuse of office. The Special Prosecutor's Office (SPO) was set up in 2015 to investigate a number of criminal offences. We consider that the latest developments could undermine public trust in the country's institutions and the opposition has called for protests and early elections on multiple occasions. We also consider that the extortion case presents a risk for the opening of EU membership talks, given the concerns among member states about the rule of law in candidate countries. However, we still expect the EU to start negotiations with North Macedonia over membership to reward it for the historic name deal.

Positively, the North Macedonian economy has continued to expand, with growth reaching 4.1% year-on-year in real terms in the first quarter of 2019. Consumption and investment have emerged as important growth drivers. The latter expanded by close to 10% year-on-year in the first quarter, mostly reflecting weak dynamics last year when some public investment projects faced delays. Private investment has also picked up, likely bolstered by strengthened political stability and the prospects of EU accession talks. We forecast that real GDP growth will reach 3% for the whole year following a 2.7% growth in 2018.

We currently don't expect further economic acceleration and anticipate that growth will remain close to current levels of 3% in the short-to-medium term. Even though there could be some upside potential from structural reforms supported by the likely start of EU membership talks, we see increasing risks for North Macedonia stemming from the weaker outlook for the European economy. EU accounts for more than 80% of North Macedonia's goods exports and Germany alone for close to 47%. Given the small and open nature of the Macedonian economy, we consider this could be a drag and we therefore project a weaker export growth of around 5.5% annually compared to almost 12% average annual export growth over the last five years.

Flexibility and performance profile: After a period of growth, we expect general government debt to GDP to gradually stabilize from 2020

North Macedonia has historically run fiscal deficits. While indebtedness is still favorable compared globally, fiscal space has somewhat eroded in recent years. This is particularly important given that North Macedonia runs a fixed exchange rate regime and, as such, fiscal policy is the main lever by which the government can influence domestic economic developments.

We forecast the general government deficit will amount to 3% of GDP this year, broadly in line with government projections and North Macedonia's past budgetary performance. This is a widening of the deficit compared to the 1.1%

of GDP outcome in 2018. Importantly, however, the stronger fiscal outturn last year mostly reflects unanticipated delays affecting some public investment projects, the implementation of which has now resumed. The 2019 deficit projection also includes a one-off clearance of arrears in the local government sector amounting to about 0.5% of GDP.

Over the last year, the government has introduced several fiscal consolidation measures. These have included an increased personal income tax rate for higher earners, higher compulsory social insurance contributions, and measures to combat the grey economy. Although we view these positively, their estimated impact is modest and we consequently project deficits averaging around 2.5% of GDP annually beyond 2019.

Reflecting our budgetary forecasts, North Macedonia's net general government debt will continue to rise until 2022, although it should stabilize at close to 45% of GDP thereafter. This compares to net general government debt of just 21% of GDP in 2010. Our calculation includes the increasing debt of the Public Enterprise for State Roads (PESR), because we believe PESR may need to rely on government transfers to service its debt in the future. In particular, a government-guaranteed €580 million loan from the Export-Import Bank of China, contracted in 2013 for the construction of two highway sections, will keep contributing to the increasing debt burden.

In the past, North Macedonia has repeatedly tapped the Eurobond market. This has made the government's balance sheet more vulnerable to potential foreign-exchange movements, because close to 80% of government debt is denominated in foreign currency, predominantly euros (including part of domestic debt). Last year, the authorities increased their borrowing in the domestic market, but they also issued a €500 million Eurobond in January 2018 at a historically low interest rate, benefiting from the European Central Bank's loose monetary policy. The government plans to maintain a regular presence in the international financial markets. We consider that the more dovish recent ECB monetary policy outlook will benefit North Macedonia, allowing the sovereign to continue borrowing in euro on favorable terms.

We forecast that North Macedonia's external indebtedness metrics will slightly decline over the next four years. We project the current account deficit will widen in 2019 to 2.5% of GDP as delayed investments take place, resulting in higher imports while current transfers moderate after an unusually strong outturn in 2018. The current account deficit will then gradually tighten and reach 1.4% of GDP in 2022, partly owing to the positive impact of the expansion of foreign companies in the free economic zones, including their closer integration with the domestic economy. We project these deficits will be financed by a combination of borrowing and net FDI inflows. This funding mix, together with declining current account deficits, will keep the country's external leverage net of external liquid assets contained at a relatively low 23%-25% of current account receipts.

The denar of North Macedonia is pegged to the euro, and we believe the existing foreign-exchange regime restricts monetary policy flexibility. However, central bank measures, such as lower reserve requirements for denar-denominated liabilities, have lowered overall euroization in North Macedonia, with foreign currency-denominated deposits and loans remaining at around 40% of total deposits and loans in recent years. We note that this is a lower proportion than in other Balkan economies and affords the National Bank of the Republic of North Macedonia (NBRM) additional room for policy response. We also consider that the limited nature of portfolio flows between North Macedonia and the rest of the world awards NBRM some extra monetary flexibility allowing for temporary deviations from the stance of the ECB.

NBRM's foreign exchange reserves have continued to grow in 2019, rising by 2% since the beginning of the year through July and reaching €2.9 billion (about 25% of GDP). Nevertheless, we believe there are vulnerabilities that could put some pressure on the existing peg in the unlikely event of confidence in the banking system taking a turn for the worse, prompting the conversion of local currency deposits into euros. This is particularly so as North Macedonia runs a pegged exchange rate arrangement while being in a net external liability position vis-à-vis the rest of the world, at 55% of GDP.

Although the Macedonian banking system has seen episodes of volatility in the past, we currently consider it to be largely stable. It remains liquid and predominantly domestic-deposit funded, with almost no external debt on a net basis (about 2% of GDP). Bank lending in North Macedonia has continued to increase in recent years. Compared to the past, trends are becoming more even, and although household lending remains higher than corporate lending, the two rates of growth have been recently converging. We expect the overall stock of domestic credit to grow by an annual average of 6% over the next four years. Meanwhile, the level of nonperforming loans has trended downward. Following the recent regulatory amendments now requiring banks to write off loans that have remained fully provisioned for over a year, NPLs amount to around 5%.

Key Statistics

Table 1

North Macedonia Selected Indicators

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Economic indicators (%)										
Nominal GDP (bil. MKD)	502	528	559	595	617	660	698	736	778	822
Nominal GDP (bil. $)	11	11	10	11	11	13	13	14	15	17
GDP per capita ($000s)	5.2	5.5	4.9	5.2	5.4	6.1	6.2	6.6	7.3	8.0
Real GDP growth	2.9	3.6	3.9	2.8	0.2	2.7	3.0	3.0	3.2	3.2
Real GDP per capita growth	2.8	3.5	3.7	2.7	0.1	2.6	2.9	2.9	3.1	3.1
Real investment growth	0.5	10.7	8.3	12.5	0.8	(7.2)	7.5	3.5	3.5	3.5
Investment/GDP	28.8	30.3	30.4	32.5	33.0	33.0	34.9	34.9	34.9	34.9
Savings/GDP	27.2	29.7	28.5	29.6	32.1	32.6	32.6	32.8	33.5	33.5
Exports/GDP	43.4	47.7	48.7	50.7	55.4	60.3	62.6	65.5	68.0	70.4
Real exports growth	6.1	16.5	8.5	9.1	8.1	15.3	6.0	6.0	5.5	5.2
Unemployment rate	29.0	28.0	26.1	23.7	22.4	20.7	17.5	17.5	17.0	17.0
External indicators (%)										
Current account balance/GDP	(1.6)	(0.6)	(1.9)	(2.9)	(0.8)	(0.4)	(2.3)	(2.1)	(1.4)	(1.4)
Current account balance/CARs	(2.5)	(0.9)	(2.8)	(4.2)	(1.1)	(0.5)	(2.8)	(2.5)	(1.7)	(1.6)
CARs/GDP	65.4	69.1	68.8	69.9	75.3	79.3	82.2	84.1	85.2	86.5
Trade balance/GDP	(22.9)	(21.7)	(20.1)	(18.8)	(17.9)	(16.2)	(16.8)	(16.6)	(16.4)	(16.4)
Net FDI/GDP	2.8	2.3	2.3	3.3	1.8	5.8	2.5	2.5	2.5	2.5
Net portfolio equity inflow/GDP	(0.4)	(0.4)	(0.4)	(0.2)	(0.4)	(0.8)	(0.5)	(0.5)	(0.7)	(0.7)
Gross external financing needs/CARs plus usable reserves	110.5	108.6	108.3	109.9	106.4	109.7	110.7	110.3	108.5	108.6

Table 1

North Macedonia Selected Indicators (cont.)										
	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Narrow net external debt/CARs	29.2	25.1	26.9	28.3	32.6	24.9	27.2	25.0	23.0	21.3
Narrow net external debt/CAPs	28.5	24.9	26.1	27.1	32.2	24.8	26.5	24.4	22.6	21.0
Net external liabilities/CARs	88.8	70.4	80.1	78.7	82.2	67.8	67.6	64.5	60.2	56.8
Net external liabilities/CAPs	86.6	69.8	77.9	75.6	81.3	67.4	65.8	63.0	59.2	55.9
Short-term external debt by remaining maturity/CARs	31.9	25.8	27.1	21.3	20.3	20.3	20.0	20.2	18.4	17.0
Usable reserves/CAPs (months)	2.5	2.0	2.3	1.6	1.7	1.2	1.3	1.3	1.3	1.1
Usable reserves (mil. $)	1,302	1,381	1,055	1,198	1,010	1,153	1,301	1,374	1,317	1,306
Fiscal indicators (general government; %)										
Balance/GDP	(4.0)	(4.2)	(3.4)	(2.7)	(2.8)	(1.1)	-3	(2.5)	(2.5)	(2.5)
Change in net debt/GDP	4.7	5.3	5.0	4.4	3.2	1.6	4.1	3.5	3.5	3.1
Primary balance/GDP	(3.1)	(3.2)	(2.3)	(1.5)	(1.5)	0.1	(1.7)	(1.1)	(0.9)	(0.7)
Revenue/GDP	30.1	29.7	31.0	30.6	31.0	30.4	30.0	30.0	30.0	30.0
Expenditures/GDP	34.1	33.9	34.4	33.2	33.9	31.5	33.0	32.5	32.5	32.5
Interest/revenues	3.1	3.3	3.8	3.8	4.4	3.9	4.2	4.8	5.4	5.9
Debt/GDP	35.7	40.7	41.6	44.7	44.5	45.9	47.5	48.6	49.4	49.9
Debt/revenues	118.8	137.2	134.3	146.2	143.3	150.8	158.3	161.9	164.8	166.2
Net debt/GDP	29.4	33.2	36.4	38.6	40.5	39.4	41.3	42.7	43.9	44.6
Liquid assets/GDP	6.3	7.5	5.2	6.1	4.0	6.5	6.2	5.8	5.5	5.2
Monetary indicators (%)										
CPI growth	2.8	(0.3)	(0.3)	(0.2)	1.4	1.5	1.4	1.8	2.0	2.5
GDP deflator growth	4.5	1.4	2.0	3.5	3.4	4.3	2.6	2.4	2.4	2.4
Exchange rate, year-end (MKD/$)	44.63	50.56	56.37	58.33	51.27	53.69	54.47	52.61	50.45	49.24
Banks' claims on resident non-gov't sector growth	6.5	9.9	9.6	0.2	5.4	7.3	5.0	6.0	6.0	6.0
Banks' claims on resident non-gov't sector/GDP	47.2	49.4	51.1	48.1	48.9	49.0	48.7	48.9	49.1	49.2
Foreign currency share of claims by banks on residents	50.8	47.5	44.8	43.8	41.7	40.3	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	43.9	41.0	41.2	41.6	40.9	40.0	N/A	N/A	N/A	N/A
Real effective exchange rate growth	1.6	1.0	(0.3)	1.1	(0.5)	1.4	N/A	N/A	N/A	N/A

Sources: National Bank of the Republic of North Macedonia,International Monetary Fund, Eurostat (Economic Indicators); National Bank of the Republic of North Macedonia,International Monetary Fund (Monetary Indicators); Ministry of Finance, National Bank of the Republic of North Macedonia (Fiscal and Debt Indicators); National Bank of the Republic of North Macedonia (External Indicators).
Adjustments: 1) We adjust usable reserves by subtracting monetary base and required bank reserves on resident foreign-currency deposits from the reported international reserves. 2) Government debt is adjusted by including the debt of Public Enterprise for State Roads.
Definitions: Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. MKD--Macedonian denar. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. e--Estimate. f--Forecast. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

North Macedonia Ratings Score Snapshot		
Key rating factors	**Score**	**Explanation**
Institutional assessment	5	Future policy responses are difficult to predict because of a still-polarized political landscape as reflected in the ongoing tensions between the governing SDSM and opposition VMRO parties. Transparency is impaired owing to high levels of perceived corruption.
Economic assessment	4	Based on GDP per capita (US$) and growth trends as per Selected Indicators in table 1.
External assessment	3	Based on narrow net external debt and gross external financing needs/(CAR + useable reserves) as per Selected Indicators in table 1.
Fiscal assessment: flexibility and performance	3	Based on the change in net general government debt (% of GDP) as per Selected Indicators in table 1.
Fiscal assessment: debt burden	3	Based on net general government debt (% of GDP) and general government interest expenditures (% of general government revenues) as per Selected Indicators in table 1. Around 80% of the gross government debt is denominated in foreign currency.
Monetary assessment	4	The North Macedonian denar is pegged to the Euro. National Bank of the Republic of North Macedonia benefits from a degree of operational independence; it uses market based monetary instruments, but their effectiveness may be untested in a downside scenario; it has some ability to act as a lender of last resort for the financial system; Annual CPI is low and in line with that of its peers.
Indicative rating	bb	As per Table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	-1	Although domestic political stability has improved, risks remain. A return of political uncertainty, for example triggered by rising ethnic tensions or a hung Parliament in the aftermath of next parliamentary election, could have a negative impact on North Macedonia's headline growth and investment dynamics, including FDI inflows. It could also negatively impact the comparatively modest per capita income levels.
Final rating		
Foreign currency	BB-	
Notches of uplift	0	Default risks do not apply differently to foreign- and local-currency debt.
Local currency	BB-	

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings List, Aug. 7, 2019
- Sovereign Ratings History, Aug. 7, 2019
- Sovereign Risk Indicators, July 11, 2019. An interactive version is also available at http://www.spratings.com/sri.
- 2018 Annual Sovereign Default And Rating Transition Study, March 15, 2019

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