Research Update:

North Macedonia 'BB-/B' Ratings Affirmed; Outlook Stable

May 13, 2020

Overview

- The coronavirus pandemic will see North Macedonia's GDP contract this year by around 5%, while the budget deficit is set to deteriorate to 7% of GDP, pushing net general government debt up to 50% of GDP.
- Nevertheless, North Macedonia is entering this difficult period with some fiscal and external buffers.
- Consequently, we are affirming our 'BB-/B' sovereign credit ratings on North Macedonia. The outlook is stable.

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Rating Action

On May 13, 2020, S&P Global Ratings affirmed its 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on the Republic of North Macedonia. The outlook is stable.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on North Macedonia are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Calendar Of 2020 EMEA Sovereign, Regional, And Local Government Rating Publication Dates," published Dec. 20, 2019, on RatingsDirect). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the reason for the deviation is a material deterioration in global economic and financial conditions as a result of the coronavirus pandemic that could have a direct impact on North Macedonia's growth, fiscal, and external metrics. The next scheduled publication on the sovereign ratings on North Macedonia will be on Sept. 4, 2020.

Outlook

The stable outlook balances the risks associated with the COVID-19 pandemic's possibly permanent effects on North Macedonia's economy and fiscal and external metrics, against potential upside from structural reform implementations as part of EU accession negotiations and stronger growth beyond 2020.

Downside scenario

We could lower the ratings on North Macedonia over the next 12 months if the economic and budgetary cost of the pandemic are materially higher than we currently project, and erode the available fiscal space, given the constraints of the exchange-rate regime. The ratings could also come under pressure if domestic financial-system stability weakens substantially in a hypothetical scenario of sustained deterioration in asset quality and persistent deposit conversion to foreign currency. We could also lower the ratings if major political tensions returned or reform momentum waned over the next 12 months, but this is not our base case.

Upside scenario

We could raise our ratings on North Macedonia if timely reform implementation, for instance as part of EU accession negotiations, strengthened its institutional arrangements and improved its economic prospects beyond 2020.

Rationale

Global economic and financial conditions have deteriorated substantially as a result of the COVID-19 pandemic, which has gathered pace over the past two months. We now expect world GDP to contract by 2.4% this year (see "COVID-19 Deals A Larger, Longer Hit To Global GDP," published on April 16, 2020). Moreover, we now project a 7.3% recession in 2020 in the eurozone, where most of North Macedonia's trade partners are.

In our view, the pandemic will have a notable effect on North Macedonia, both directly (with pressures on the health sector and the economy as a result of measures to stop the spread of the virus) and indirectly (via the foreign trade channel). We have revised our growth forecasts down and now expect the economy to contract by 5.0% in 2020, followed by a partial recovery of 3.8% next year. We anticipate that the recession will be rather broad-based, with a sharp contraction in exports but also shrinking domestic consumption and investments.

Although global tourism is being heavily affected, its significance for North Macedonia is relatively limited given that tourism receipts directly account for only about 5% of total nominal exports in U.S. dollar terms. More significantly, North Macedonia is part of global supply chains, particularly in the auto sector, in which activity will likely remain weak in the coming months. We note that Germany alone is a destination for almost 50% of North Macedonia's exports; we forecast the German economy will contract by 6% this year. North Macedonia has also historically relied on worker remittances--these comprise the bulk of the secondary income surplus, which averaged close to 17% of GDP over the last five years. The workers are mostly in Europe and we expect transfers to fall sharply, by 25% in 2020, as economic conditions in host countries worsen. Consequently, this will put further downward pressure on domestic demand.

Our economic forecasts are subject to a high degree of uncertainty with risks tilted to the downside. A second wave of the virus, either in North Macedonia or in Europe, could worsen the outlook for recovery. At the same time, we have yet to see whether activity will be resumed in full once social distancing measures are relaxed. Some companies might have to be liquidated because of their weakened financial standing, combined with still-subdued demand from cautious consumers. We note that North Macedonia has already started to lift some restrictions but we expect this to be a gradual process.

The government and the national bank have to date announced fiscal and monetary measures to support the economy through the pandemic. These include:

- A number of support measures to the affected sectors, including transport, hotels, and restaurants as well as a subsidy on social security contributions to maintain employment (0.3% of GDP);
- Direct support to protect jobs in companies where revenue dropped by over 30% as a result of the pandemic and measures to protect the vulnerable in the informal economy (1% of GDP); and
- Several monetary and credit measures, including a reduction in the key central bank interest rate, widening eligible collateral for monetary operations purposes, as well as some forbearance measures and targeted debt payment holidays.

We forecast that as a result of the aforementioned initiatives and the projected decline in economic activity, the general government deficit will widen to 7.0% of GDP this year from 2.1% last year. The main contributor to this widening will likely be the eroding revenue base, while the government plans to keep expenditures largely unchanged (with spending shifted from capital spending to healthcare outlays and support measures). Specifically, high frequency data suggests that while PIT has held up comparatively well so far, there has been a notable drop in VAT and excise collections.

The authorities plan to fund the deficit mainly via borrowing from international financial institutions. In fact, a Rapid Financing Instrument credit line of €176 million has already been agreed with the IMF and disbursed, while negotiations continue with the EU, World Bank, and others for further support. The North Macedonian government also plans to issue a Eurobond in the coming months.

Although we still view North Macedonia's fiscal leverage as moderate, we believe there will be some permanent erosion of fiscal space as a result of the pandemic and ensuing recession. We now project that net general government debt will rise to above 50% of GDP by the end of 2020 compared to 41% at the end of 2019. We also expect net general government debt to be on average 9% of GDP higher over the medium term compared to our previous projections.

Similar to our fiscal projections, we expect the current account deficit to widen this year to about 6.0% of GDP from 2.8% last year. This largely mirrors public-sector foreign borrowing to offset the impact of the pandemic. Although we forecast a pronounced decline in remittances of 25% in U.S. dollar terms, we anticipate that imports will decline in tandem, limiting the overall effect on the headline external balance.

North Macedonia's banking system remains stable but risks have increased, in our view. Asset quality will likely deteriorate and there were also some deposit withdrawals and conversions to foreign exchange throughout April. We understand that this is no longer happening and high frequency data suggests that central bank reserves grew in gross terms in April.

We expect the pegged denar-euro exchange rate arrangement to remain in place for the foreseeable future. The absence of large-scale portfolio flows into North Macedonia somewhat relieves immediate risks but these remain given the bleak outlook for remittances and FDI. Our baseline expectation is that there will be no large-scale resident conversion to foreign exchange and therefore the exchange rate will remain intact.

Beyond the current impact of the coronavirus pandemic, we note that there have been several important developments in North Macedonia. In March the country finally got the green light to formally start EU accession talks, following the resolution of its long-running name dispute with Greece in 2019. We believe that negotiations could bring upside potential in terms of structural reform implementation. We also observe notable improvements in political stability in recent years, with an orderly precedent of power transfer in 2017. Risks remain, however, as the country gears up for the general elections later this year. These were postponed from April due to the pandemic. The two main parties are polling closely, presenting risks of a hung parliament, although this is not our baseline scenario.

Key Statistics

Table 1

North Macedonia Selected Indicators

MKD mil.	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic indicators (%)										
Nominal GDP (bil. LC)	528	559	595	617	658	698	666	702	740	781
Nominal GDP (bil. $)	11	10	11	11	13	13	12	13	14	14
GDP per capita (000s $)	5.5	4.9	5.2	5.4	6.1	6.1	5.7	6.2	6.5	6.8
Real GDP growth	3.6	3.9	2.8	1.1	2.7	3.6	(5.0)	3.8	3.2	3.2
Real GDP per capita growth	3.5	3.7	2.7	1.0	2.6	3.5	(5.1)	3.7	3.1	3.1
Real investment growth	10.7	8.3	12.5	(2.2)	(7.3)	6.6	(7.0)	7.0	3.5	3.5
Investment/GDP	30.3	30.4	32.5	33.0	31.9	34.1	32.6	34.3	34.4	34.6
Savings/GDP	29.7	28.5	29.6	32.1	31.7	31.3	26.9	31.5	31.7	32.5
Exports/GDP	47.7	48.7	50.7	55.4	60.6	61.7	57.1	59.7	62.1	64.6
Real exports growth	16.5	8.5	9.1	8.3	15.6	8.3	(8.0)	5.5	5.0	5.0
Unemployment rate	28.0	26.1	23.7	22.4	20.7	17.3	19.0	18.0	17.0	16.0
External indicators (%)										
Current account balance/GDP	(0.6)	(1.9)	(2.9)	(0.9)	(0.2)	(2.8)	(5.7)	(2.8)	(2.7)	(2.1)
Current account balance/CARs	(0.9)	(2.8)	(4.2)	(1.1)	(0.3)	(3.5)	(8.0)	(3.6)	(3.4)	(2.5)
CARs/GDP	69.1	68.8	69.9	75.3	79.7	79.4	71.9	76.5	79.4	82.1
Trade balance/GDP	(21.7)	(20.1)	(18.8)	(17.9)	(16.3)	(17.3)	(18.0)	(18.2)	(17.9)	(17.5)
Net FDI/GDP	2.3	2.3	3.3	1.8	5.6	2.5	0.5	3.0	2.5	2.5
Net portfolio equity inflow/GDP	(0.4)	(0.4)	(0.2)	(0.4)	(0.8)	(0.0)	(0.5)	(0.7)	(0.7)	(0.7)
Gross external financing needs/CARs plus usable reserves	108.6	108.3	109.9	106.4	109.5	111.5	118.1	118.2	118.5	117.1
Narrow net external debt/CARs	25.1	26.9	28.3	32.6	24.4	23.4	37.8	34.3	33.5	32.4
Narrow net external debt/CAPs	24.9	26.1	27.1	32.2	24.3	22.6	35.0	33.1	32.4	31.6
Net external liabilities/CARs	70.4	80.1	78.7	82.2	68.7	71.0	91.8	83.0	80.0	77.9
Net external liabilities/CAPs	69.8	77.9	75.6	81.3	68.5	68.6	85.0	80.1	77.4	75.9

Table 1

North Macedonia Selected Indicators (cont.)

MKD mil.	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Short-term external debt by remaining maturity/CARs	25.8	27.1	21.3	20.3	20.3	20.8	25.9	21.7	20.1	18.9
Usable reserves/CAPs (months)	2.0	2.3	1.6	1.7	1.2	1.3	1.5	0.7	0.5	0.4
Usable reserves (mil. $)	1,381	1,055	1,198	1,010	1,153	1,136	594	447	420	393
Fiscal indicators (general government; %)										
Balance/GDP	(4.2)	(3.4)	(2.7)	(2.8)	(1.1)	(2.1)	(7.0)	(3.0)	(2.0)	(2.0)
Change in net debt/GDP	5.3	5.0	4.4	3.2	1.6	3.6	8.1	3.6	2.6	2.2
Primary balance/GDP	(3.2)	(2.3)	(1.5)	(1.5)	0.1	(1.0)	(5.7)	(1.5)	(0.4)	(0.4)
Revenue/GDP	29.7	31.0	30.6	31.0	30.5	31.2	27.0	30.5	30.5	30.5
Expenditures/GDP	33.9	34.4	33.2	33.9	31.6	33.3	34.0	33.5	32.5	32.5
Interest/revenues	3.3	3.8	3.8	4.4	3.9	3.8	4.9	4.9	5.4	5.3
Debt/GDP	40.7	41.6	44.7	44.5	46.0	46.3	56.7	57.4	57.1	56.3
Debt/revenues	137.2	134.3	146.2	143.3	150.8	148.7	209.9	188.3	187.1	184.6
Net debt/GDP	33.2	36.4	38.6	40.5	39.5	40.9	50.9	52.0	51.9	51.4
Liquid assets/GDP	7.5	5.2	6.1	4.0	6.5	5.5	5.7	5.4	5.2	4.9
Monetary indicators (%)										
CPI growth	(0.3)	(0.3)	(0.2)	1.4	1.5	0.8	0.2	0.8	1.4	1.4
GDP deflator growth	1.4	2.0	3.5	2.6	3.9	2.4	0.5	1.5	2.2	2.2
Exchange rate, year-end (LC/$)	50.56	56.37	58.33	51.27	53.69	54.95	55.95	54.12	54.92	55.74
Banks' claims on resident non-gov't sector growth	9.9	9.6	0.2	5.4	7.3	6.4	(2.0)	6.0	6.0	6.0
Banks' claims on resident non-gov't sector/GDP	49.4	51.1	48.1	48.9	49.2	49.3	50.6	50.9	51.2	51.5
Foreign currency share of claims by banks on residents	47.5	44.8	43.8	41.7	40.3	41.2	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	41.0	41.2	41.6	40.9	40.0	38.4	N/A	N/A	N/A	N/A
Real effective exchange rate growth	1.0	(0.3)	1.1	(0.5)	1.4	(1.7)	N/A	N/A	N/A	N/A

Sources:National Bank of the Republic of North Macedonia,International Monetary Fund, Eurostat, State Statistical Office of Republic of North Macedonia (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. LC--Local currency. 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 + usable 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 Risk Indicators, April 24, 2020. Interactive version available at http://www.spratings.com/sri
- Sovereign Ratings History, April 7, 2020
- Sovereign Ratings List, April 7, 2020
- 2018 Annual Sovereign Default And Rating Transition Study, March 15, 2019

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed	
North Macedonia	
Sovereign Credit Rating	BB-/Stable/B
Transfer & Convertibility Assessment	BB
Senior Unsecured	BB-

box located in the left column. Alternatively, call one of the following S&P Global Ratings 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.