Research Update:

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

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Overview

- The coronavirus pandemic will weigh on the economic recovery of North Macedonia despite early measures to contain the virus.
- We forecast that real GDP will contract by 6% this year followed by only a partial recovery in 2021, while the fiscal and balance-of-payments performances weaken.
- The higher 2020 fiscal deficit is funded through official lenders and a Eurobond placement in June. We forecast that net general government debt should stabilize at close to 54% of GDP through 2023, leaving some fiscal policy space.
- We are therefore affirming our 'BB-/B' sovereign credit ratings on North Macedonia. The outlook is stable.

Rating Action

On Sept. 4, 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.

Outlook

The stable outlook balances the disruptive effects of the COVID-19 pandemic on North Macedonia's economy and fiscal and external metrics over the next year, against potential upside from strengthening institutional arrangements and structural reform implementation as part of EU accession negotiations, as well as stronger growth beyond 2020.

Downside scenario

We could lower the ratings on North Macedonia if the ultimate economic and budgetary costs of the pandemic are materially higher than we currently project, and erode the available fiscal space, given the constraints of the exchange-rate regime. Downside pressure could also build if, rather than stabilizing, net general government debt continues to grow as a proportion of GDP over the medium term. The ratings could also come under pressure if domestic financial-system stability weakens substantially in a hypothetical scenario of sustained deterioration in asset quality or persistent deposit conversion to foreign currency.

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.

Rationale

The affirmation reflects our view that, despite the sharp economic contraction in 2020 and related deterioration in fiscal and external metrics, North Macedonia will weather this period of heightened uncertainty and will still have some fiscal policy space to maneuver afterward. Favorable longer-term growth potential, our expectation that debt will increase but then stabilize at moderate levels, and access to funding through official and market sources are factors that support the ratings. Our ratings on North Macedonia are constrained by our view of its relatively low income levels; shortcomings in its institutional settings despite recent improvements; and limited monetary policy flexibility arising from the fixed exchange-rate regime.

We expect that the global pandemic will impair North Macedonia's economic performance. Specifically, we project output will contract by 6% in real terms in 2020, with all key components exhibiting a weak dynamic including exports, investments, and domestic consumption. Notwithstanding our base-case projection that real economic growth will be around 3.5% in 2021, recovery prospects remain uncertain.

Institutional and economic profile: Record output drop in 2020 because of the pandemic

- We forecast that North Macedonia's economy will contract by 6.0% in 2020, followed by a partial recovery of around 3.5% in 2021.
- Our economic forecasts are uncertain due to the still-high prevalence of the virus in the country and downside risks to North Macedonia's key trade partners' performance.
- We expect that the SDSM-centered government formed after the July 2020 general election will maintain the policy direction of recent years.

COVID-19 is having a significant adverse effect on North Macedonia, both directly (through the impact of restrictions implemented earlier and the remaining social distancing measures) and indirectly (via the foreign trade channel). We expect world GDP will contract by 3.8% this year (see "The Global Economy Begins A Slow Mend As COVID-19 Eases Unevenly," published July 1, 2020, on RatingsDirect). Moreover, we now project a 7.8% recession in 2020 in the eurozone, where most of North Macedonia's trade partners are located.

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 belongs to global supply chains, particularly in the auto sector, in which activity has been subdued. Germany alone is a destination for almost 50% of North Macedonia's exports. Of total exports to Germany, around 80% pertains to various auto components. We forecast the German economy will contract by 6.2% 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.

Aside from its impact via trade partners, we consider that coronavirus presents direct risks for the domestic economy, making macroeconomic outcomes difficult to forecast. Following a relatively mild first wave during March-May, new cases have increased rapidly since the beginning of June as earlier restrictions and social distancing measures have been gradually eased. New cases peaked at the end of July and have since started to moderate, but numbers still remain elevated and much higher than during spring. In our view, this presents risks, particularly if another resurgence of the coronavirus prompts the authorities to re-introduce some of the restrictions lifted earlier.

We have slightly lowered our economic forecasts since our last publication in May and now expect the North Macedonian economy to contract by 6.0% in 2020 (5.0% previously) followed by a 3.5% recovery in 2021 (3.8% previously). We think that it will take North Macedonia until 2022 to restore its 2019 real output value. Our forecast revision is largely driven by high frequency economic data, which suggests that--despite improvements in recent months--many indicators remain in negative territory in year-on-year terms. In June, for example, industrial production was still 15% lower year-on-year, while turnover in wholesale and retail trade was 25% lower. In terms of expenditure, we expect this year's contraction to be broad-based with exports, investments, and domestic consumption all falling notably.

North Macedonia held a general election on July 15 and the new government was approved in a parliamentary vote at the end of August. The election was originally scheduled for April but was postponed because of the pandemic. The two main parties--the Social Democratic Union (SDSM) and the opposition VMRO-DPMNE--gained a similar vote share with SDSM getting ahead only slightly and gaining 46 seats as opposed to VMRO's 44. Similar close outcomes have occurred on multiple previous occasions and often precipitated a political crisis and a parliamentary gridlock with neither side being able to easily secure a working majority.

In our view, prompt government formation should enable a better focus on managing the fallout from this year's large economic recession, taking into account that North Macedonia has effectively been led by a caretaker administration until now. The two parties comprising the new coalition--SDSM and the ethnic Albanian Democratic Union for Integration (DUI)--had previously been in government since May 2017 and, as such, we expect policy priorities to remain broadly unchanged. Beyond managing the fallout from the pandemic in 2020, we think the government will focus on closer integration with the EU, including making progress on membership negotiations, as well as measures to attract foreign direct investment and diversify the economy. Overall, we observe notable improvements in political stability in recent years, with an orderly precedent of power transfer in 2017 and smooth conduct of elections in 2020.

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. Nevertheless, this would likely be a gradual process and we do not expect North Macedonia to become a member of the EU this decade.

Flexibility and performance profile: Fiscal and balance-of-payments performances will deteriorate, but policy headroom remains

- We forecast that the budgetary performance will deteriorate with net general government debt rising to 51% of GDP in 2020 from 41% in 2019.
- Balance-of-payments performance will also weaken on a decline in exports and remittances but the central bank's foreign exchange (FX) reserves in 2020 are supported by foreign commercial and multilateral borrowing.
- We expect the peg of the Macedonian denar to the euro to remain intact.

The government and the National Bank have to date announced several fiscal and monetary measures to offset the effects of the pandemic on the domestic economy. These include:

- Support measures to affected sectors, including transport, hotels, and restaurants, as well as a subsidy on social security contributions to maintain employment;
- 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; and
- Several monetary and credit measures, including a reduction in the key central bank interest rate, widening eligible collateral for monetary operations purposes, reducing the offered amount of central bank bills and thus providing extra liquidity, as well as some forbearance measures and targeted debt payment holidays.

We forecast that, as a result of these 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. We have not changed this forecast since our previous publication in May because the high frequency data is largely in line with what we previously expected: the half-year general government deficit was 3.8% of GDP. Beyond 2020, we have revised our fiscal projections slightly downward reflecting the elevated uncertainty with respect to economic growth and the ability of the new government to quickly consolidate public finances, particularly given its slim majority in Parliament.

To fund the deficit, the authorities have agreed credit lines from several international financial institutions. A Rapid Financing Instrument credit line of €176 million from the IMF has been disbursed, while negotiations have concluded on a €160 million facility from the EU, which will be disbursed in two tranches in the coming months. Positively, North Macedonia also issued a €700 million Eurobond in June. Despite the volatile sentiment and fund flows toward emerging markets this year, the instrument was 5x oversubscribed. We estimate that the aforementioned borrowing will cover North Macedonia's budget deficit and debt repayments for the rest of this year, while also leaving the country with a 6% of GDP cash buffer by the end of 2020.

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 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 10% of GDP higher over the medium term compared to our projections before the pandemic.

Similar to our fiscal projections, we expect the current account deficit to widen this year to about 4.5% of GDP from 2.8% last year. 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 FX briefly throughout April. This has since stopped and high frequency data suggests that at the end of July central bank reserves were 10% higher compared to end-2019, because of foreign borrowing.

In mid-August the regulator revoked a license from a small domestic bank, Eurostandard. We understand that this is not directly related to the pandemic and that the bank had been vulnerable and undercapitalized beforehand. Its share in total domestic credit and deposits is small at below 2% and as such we do not expect any systemic repercussions. The government is not involved in its resolution and insured deposit payouts will be funded by the deposit guarantee fund with no budget involvement.

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 FX and therefore the exchange rate will remain intact. The National Bank of the Republic of North Macedonia has also recently agreed a €400 million repo line with the ECB, which could be deployed in a downside scenario. None of this amount has been deployed so far.

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	618	658	698	667	700	739	780
Nominal GDP (bil. $)	11	10	11	11	13	13	12	13	14	14
GDP per capita (000s $)	5.5	4.9	5.2	5.5	6.1	6.1	5.8	6.3	6.5	6.8
Real GDP growth	3.6	3.9	2.8	1.1	2.7	3.6	(6.0)	3.5	3.2	3.2
Real GDP per capita growth	3.5	3.7	2.7	1.0	2.6	3.5	(6.1)	3.4	3.1	3.1
Real investment growth	10.7	8.3	12.5	(2.2)	(7.3)	6.6	(7.0)	5.0	3.5	3.5
Investment/GDP	30.3	30.4	32.5	32.3	31.9	34.1	32.5	33.7	33.8	33.9
Savings/GDP	29.7	28.5	29.6	31.4	31.7	31.3	28.1	30.7	31.1	31.9
Exports/GDP	47.7	48.7	50.7	55.1	60.6	61.7	54.3	59.1	60.3	61.4
Real exports growth	16.5	8.5	9.1	8.3	15.6	8.3	(16.0)	12.0	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)	(4.5)	(3.0)	(2.7)	(2.0)
Current account balance/CARs	(0.9)	(2.8)	(4.2)	(1.1)	(0.3)	(3.5)	(6.5)	(3.9)	(3.4)	(2.5)
CARs/GDP	69.1	68.8	69.9	75.1	79.7	79.4	68.8	76.2	78.1	79.4
Trade balance/GDP	(21.7)	(20.1)	(18.8)	(17.8)	(16.3)	(17.3)	(16.7)	(17.9)	(17.3)	(16.7)

Table 1

North Macedonia Selected Indicators (cont.)

MKD mil.	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Net FDI/GDP	2.3	2.3	3.3	1.8	5.6	2.5	0.5	2.0	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	117.0	115.3	115.6	114.5
Narrow net external debt/CARs	25.1	26.9	28.3	32.6	24.4	23.4	35.9	32.6	32.7	31.5
Narrow net external debt/CAPs	24.9	26.1	27.1	32.2	24.3	22.6	33.7	31.4	31.6	30.8
Net external liabilities/CARs	70.4	80.1	78.7	82.2	68.7	71.0	92.3	80.9	79.8	78.4
Net external liabilities/CAPs	69.8	77.9	75.6	81.3	68.5	68.6	86.7	77.8	77.2	76.5
Short-term external debt by remaining maturity/CARs	25.8	27.1	21.3	20.3	20.3	20.8	26.4	23.5	22.3	21.3
Usable reserves/CAPs (months)	2.0	2.3	1.6	1.7	1.2	1.3	1.5	1.2	1.0	0.9
Usable reserves (mil. $)	1,381	1,055	1,198	1,010	1,153	1,136	1,047	930	905	880
Fiscal indicators (general government; %)										
Balance/GDP	(4.2)	(3.4)	(2.7)	(2.8)	(1.1)	(2.1)	(7.0)	(3.5)	(3.0)	(3.0)
Change in net debt/GDP	5.3	5.0	4.4	3.2	1.6	3.6	8.1	4.1	3.6	3.2
Primary balance/GDP	(3.2)	(2.3)	(1.5)	(1.5)	0.1	(1.0)	(5.7)	(2.0)	(1.3)	(1.3)
Revenue/GDP	29.7	31.0	30.6	31.0	30.5	31.2	29.0	30.5	30.5	30.5
Expenditures/GDP	33.9	34.4	33.2	33.8	31.6	33.3	36.0	34.0	33.5	33.5
Interest/revenues	3.3	3.8	3.8	4.4	3.9	3.7	4.5	5.0	5.6	5.6
Debt/GDP	40.7	41.6	44.7	44.4	46.0	46.3	56.6	58.1	58.6	58.7
Debt/revenues	137.2	134.3	146.2	143.3	150.8	148.8	195.2	190.4	192.2	192.6
Net debt/GDP	33.2	36.4	38.6	40.4	39.5	40.9	50.9	52.6	53.5	53.8
Liquid assets/GDP	7.5	5.2	6.1	4.0	6.5	5.5	5.7	5.5	5.2	4.9
Monetary indicators (%)										
CPI growth	(0.3)	(0.3)	(0.2)	1.4	1.5	0.8	0.6	1.2	1.4	1.4
GDP deflator growth	1.4	2.0	3.5	2.8	3.6	2.4	1.7	1.4	2.3	2.3
Exchange rate, year-end (LC/$)	50.56	56.37	58.33	51.27	53.69	54.95	53.70	53.99	54.85	55.73
Banks' claims on resident non-gov't sector growth	9.9	9.6	0.2	5.4	7.3	6.4	5.0	6.0	6.0	6.0
Banks' claims on resident non-gov't sector/GDP	49.4	51.1	48.1	48.8	49.2	49.3	54.2	54.7	54.9	55.2
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

Table 1

North Macedonia Selected Indicators (cont.)

MKD mil.	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
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 claims on 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. 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 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	4	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 75% 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."

Table 2

North Macedonia Ratings Score Snapshot (cont.)

Key rating factors	Score	Explanation
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 because the government loses the current slim Parliamentary majority 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. There are also downside risks stemming from the pandemic's impact on North Macedonian economy.
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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings List, Aug. 17, 2020
- Sovereign Ratings History, Aug. 17, 2020
- Sovereign Risk Indicators, July 14, 2020. Interactive version available at http://www.spratings.com/sri
- Default, Transition, and Recovery: 2019 Annual Sovereign Default And Rating Transition Study, May 18, 2020

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-