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Ratings

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Research Update:

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

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Overview

- The Republic of North Macedonia's resolution of the long-lasting name dispute with Greece in January 2019 is a major milestone, but we do not expect to see an immediate material effect on North Macedonia's economy.
- We expect North Macedonia to formally begin EU accession talks this year. This could accelerate a number of structural reforms as part of the negotiations, although EU membership is unlikely in the near future.
- We are affirming the 'BB-/B' long- and short- term sovereign ratings on North Macedonia. The outlook is stable.

Rating Action

On March 8, 2019, S&P Global Ratings affirmed its long- and short-term foreign and local currency sovereign credit ratings on the Republic of North Macedonia at 'BB-/B'. The outlook is stable.

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: Name dispute resolution and restored political stability underpin a return of growth

- Following stagnation in 2017, we estimate that the North Macedonian economy grew by 2.5% in real terms last year.
- The resolution of the name dispute with Greece opens the door to NATO membership and the formal start of EU accession talks.
- We do not expect any notable policy changes after the April 2019 presidential elections, given the largely ceremonial function of president in North Macedonia.

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 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 has already been 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 and the start of formal EU accession talks in the coming months. Although North Macedonia has been an EU candidate since 2005, no progress on membership talks has been achieved due to being blocked by Greece.

In addition to a number of important reforms adopted recently, North Macedonia still needs to implement some changes before EU negotiations can begin. We understand that these include undertaking a public administration reform, passing a new anti-corruption law, and adopting legislation to strengthen the judicial system. Potential hurdles could also stem from the European Parliament elections this year owing to growing EU skepticism and enlargement fatigue. Nevertheless, we believe these will be overcome given the already-substantial progress achieved to date. Our baseline expectation now is that North Macedonia's accession talks will start in the coming months.

In our view, the start of EU accession talks could accelerate reform momentum as North Macedonia implements the 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 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.

In addition to resolving the name dispute, North Macedonia has recently undergone an orderly power transfer that we believe has set an important precedent given that the country's political stage had been dominated by the VMRO-DPMNE party for more than 10 years previously. Despite the close 2016 election outcome, SDSM ultimately succeeded in forming a government in May 2017 and has now been in office for almost two years. We consider that the power transfer and the subsequent ability of SDSM to govern goes some way toward strengthening various public institutions, even though checks and balances and policy predictability still remain weak. To this end, we note the high levels of perceived corruption and the difficulties in enforcing some judicial decisions seen, for instance, in the escape of former prime minister Nikola Gruevski abroad, despite facing charges domestically.

North Macedonia is currently gearing up for presidential elections scheduled for April 2019, but we expect limited policy changes in the aftermath. This is primarily because the presidential post is largely ceremonial in North Macedonia. The incumbent president Gjorge Ivanov supports the main opposition VMRO party but he is due to step down in May 2019 given the end of his second term in office.

In line with our previous expectations, North Macedonia's economy returned to growth last year, following stagnation in 2017. We estimate that output expanded by 2.5% in real terms in 2018. Although we view the resolution of the name dispute as an important development, we consider that the return of political stability has been at least as important in helping accelerate economic dynamics. We currently do not expect the resolution of the name dispute to substantially alter North Macedonia's growth performance in the short term.

We project that the economy will grow by 3% on average over the next three years. Domestic consumption and exports will remain important growth drivers. Meanwhile, we expect a stronger outturn for investments after an estimated 8% real contraction in 2018. This will happen on account of both rising private investments owing to improved political stability, as well as accelerating public capital expenditure (capex) following the substantial under-use of the capex budget last year on delays in a publicly-funded road construction, among other things.

We currently view risks to our economic projections as broadly balanced. There is upside potential from faster government reform implementation, which could ultimately improve the business environment and subsequently lead to larger FDI inflows. At the same time, there are risks from softening growth in Europe, where most of North Macedonia's trade partners are. To this end, there are also some risks from the U.S. introducing tariffs on car imports, which could indirectly affect North Macedonia mainly via its exposures to other European economies. Overall, at around $6,000, North Macedonia's per capita income remains modest in a global comparison, and substantially faster economic growth is needed to ensure convergence with average EU income levels.

We continue to believe that the economy's long-term growth prospects could benefit from the expansion of free economic zones and their better integration into the local economy by using local suppliers. We note that, so far, most inputs for goods assembled by foreign companies have been imported. Consequently, the free zones' effect on the rest of the economy has been less than might be expected and largely confined to employment. That said, there are examples of some companies increasingly using domestic suppliers.

Flexibility and Performance Profile: After a period of growth, we expect public debt to GDP to gradually stabilize from 2020

- North Macedonia's public debt burden remains moderate in a global context, but there has been an erosion of fiscal space in recent years.
- Although downside risks remain, we expect net general government debt to gradually stabilize at about 45% of GDP in 2021-2022 after a prolonged period of growth.
- North Macedonia's monetary flexibility is higher than that of other Balkan states, but the denar's peg to the euro still constrains the central bank's policies.

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.

Despite the 2018 fiscal deficit being lower than we previously projected, this was mainly a result of much lower capex, including delays in several construction projects. We understand this under-execution was caused by some difficulties in procurement procedures.

We expect the fiscal deficit to expand in 2019, partially from accelerating capex following last year's delays. Current expenditures, namely salaries and transfers, will continue to account for the lion's share of government spending, as is typical for other countries in the region. The government introduced progressive personal income tax but we expect the effect to be limited (<0.5% of GDP). Overall, we expect the general government deficit will expand to 3% of GDP this year, in line with the government's projection.

Deficits should then slightly moderate, averaging close to 2.5% of GDP over 2020-2022.

We view positively the recent pension system reform. Currently North Macedonia spends about 10% of GDP on pensions, among the highest in the region, while the pension deficit amounts to about 4% of GDP, according to IMF estimates. The changes removed the double-indexation system (50% CPI/50% wage growth) for pensions, anchoring growth to CPI only, and increased contributions to the system.

The authorities also aim to continue public financial management reform with a focus on improved transparency, budgeting, and oversight. We understand that work is ongoing to clear the arrears outstanding at various levels of government. In the supplementary 2018 budget, €50 million (0.5% of GDP) was allocated to municipal entities to clear past obligations.

Reflecting our budgetary forecasts, North Macedonia's net general government debt will continue to rise until 2022, although it should stabilize at close to 44% 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. We believe the favorable terms have also been helped by the improved domestic political stability. The government plans to maintain a regular presence in the international financial markets.

With the public sector increasingly borrowing abroad, the economy's external debt has been rising. In 2018, we estimate that gross external debt, net of liquid financial and public-sector assets amounted to 27% of current account receipts.

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% 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.

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.

The central bank's gross foreign exchange reserves have been on the rise in 2018. While the Eurobond issue in January gave an initial uplift, upward pressure on the denar of North Macedonia led the bank to purchase more than €350 million in foreign currency to maintain the existing exchange rate. 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 and prompting 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 60% of GDP.

North Macedonia's banking system, which is predominantly foreign owned, has seen several bouts of volatility in recent years. For example, political developments caused deposit outflows from North Macedonia's banking sector in April 2016, although the majority of funds quickly returned in the aftermath. In general, the banking system appears well capitalized and profitable, and it is largely funded by domestic deposits. Positively, North Macedonia's regulatory and supervisory framework under the NBRM has proven resilient to past episodes of volatility; the NBRM reacted swiftly to the volatility in April 2016 by raising interest rates and intervening in the foreign exchange market to support the currency peg, as well as deploying several other measures. At present, we estimate that nonperforming loans in the system amount to about 5% of the total, which compares favorably with other countries in the region.

Bank lending in North Macedonia has continued to increase in recent years. Compared to the past, trends are becoming more even: even though household lending remains higher than corporate, the two rates have been recently converging. We expect the overall stock of domestic credit to grow by an annual average of 7% over the next four years.

Key Statistics

Table 1

North Macedonia Selected Indicators

MKD Mil.	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Economic indicators (%)										
Nominal GDP (bil. MKD)	502	528	559	595	617	657	695	735	780	828
Nominal GDP (bil. $)	11	11	10	11	11	13	13	15	16	17
GDP per capita (000s $)	5.2	5.5	4.9	5.2	5.4	6.1	6.3	7.1	7.6	8.1
Real GDP growth	2.9	3.6	3.9	2.8	0.2	2.5	3.0	3.0	3.2	3.2
Real GDP per capita growth	2.8	3.5	3.7	2.7	0.1	2.4	2.9	2.9	3.1	3.1
Real investment growth	0.5	10.7	8.3	12.5	0.8	-8	7.5	3.0	3.0	2.7
Investment/GDP	28.8	30.3	30.4	32.5	33.0	32.4	34.1	34.3	34.5	34.5
Savings/GDP	27.2	29.7	28.5	29.6	32.1	32.1	31.6	32.5	33.1	33.5
Exports/GDP	43.4	47.7	48.7	50.7	55.4	58.8	61.1	63.6	65.7	67.7
Real exports growth	6.1	16.5	8.5	9.1	8.1	11.5	6.0	6.0	5.5	5.0
Unemployment rate	29.0	28.0	26.1	23.7	22.4	20.8	20.5	20.0	20.0	20.0
External indicators (%)										
Current account balance/GDP	(1.6)	(0.6)	(1.9)	(2.9)	(0.8)	(0.4)	(2.5)	(1.8)	(1.4)	(1.0)
Current account balance/CARs	(2.5)	(0.9)	(2.8)	(4.2)	(1.1)	(0.5)	(3.0)	(2.2)	(1.7)	(1.2)
CARs/GDP	65.4	69.1	68.8	69.9	75.3	79.7	82.0	83.0	84.3	85.7
Trade balance/GDP	(22.9)	(21.7)	(20.1)	(18.8)	(17.9)	(16.3)	(16.9)	(16.3)	(15.7)	(15.4)
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)	(0.5)	(0.5)
Gross external financing needs/CARs plus usable reserves	110.5	108.6	108.3	109.9	106.4	109.9	110.4	111.2	111.1	110.3
Narrow net external debt/CARs	29.2	25.1	26.9	28.3	32.6	26.8	27.3	25.7	24.0	22.5
Narrow net external debt/CAPs	28.5	24.9	26.1	27.1	32.2	26.6	26.5	25.1	23.6	22.3
Net external liabilities/CARs	88.8	70.4	80.1	78.7	82.2	75.0	72.8	67.6	64.4	62.0
Net external liabilities/CAPs	86.6	69.8	77.9	75.6	81.3	74.7	70.7	66.1	63.3	61.3
Short-term external debt by remaining maturity/CARs	31.9	25.8	27.1	21.3	20.3	20.5	19.2	18.1	17.2	16.7
Usable reserves/CAPs (months)	2.5	2.0	2.3	1.6	1.7	1.2	1.2	1.0	0.8	0.8
Usable reserves (mil. $)	1,302	1,381	1,055	1,198	1,010	1,153	1,001	933	983	1,098
Fiscal indicators (general government; %)										
Balance/GDP	(4.0)	(4.2)	(3.4)	(2.7)	(2.8)	(1.1)	(3.0)	(2.5)	(2.5)	(2.5)
Change in net debt/GDP	4.7	5.3	5.0	4.3	3.4	1.7	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)	(1.0)	(0.9)	(0.8)
Revenue/GDP	30.1	29.7	31.0	30.6	31.0	30.6	30.5	30.0	30.0	30.0
Expenditures/GDP	34.1	33.9	34.4	33.2	33.9	31.6	33.5	32.5	32.5	32.5
Interest/revenues	3.1	3.3	3.8	3.8	4.4	3.9	4.3	4.9	5.4	5.6
Debt/GDP	35.7	40.7	41.6	44.5	44.5	46.3	46.7	47.7	48.4	48.7
Debt/revenues	118.8	137.2	134.3	145.7	143.3	151.4	153.2	158.8	161.4	162.3
Net debt/GDP	29.4	33.2	36.4	38.5	40.5	39.6	41.6	42.8	43.8	44.4
Liquid assets/GDP	6.3	7.5	5.2	6.1	4.0	6.7	5.1	4.9	4.6	4.3

Table 1

North Macedonia Selected Indicators (cont.)										
MKD Mil.	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Monetary indicators (%)										
CPI growth	2.8	(0.3)	(0.3)	(0.2)	1.4	1.5	2.0	2.2	2.5	2.5
GDP deflator growth	4.5	1.4	2.0	3.5	3.4	4.0	2.6	2.8	2.8	2.8
Exchange rate, year-end (MKD/$)	44.63	50.56	56.37	58.33	51.27	53.69	51.29	49.44	49.24	49.24
Banks' claims on resident non-gov't sector growth	6.5	9.9	9.6	0.2	5.4	7.3	8.0	8.0	6.0	6.0
Banks' claims on resident non-gov't sector/GDP	47.2	49.4	51.1	48.1	48.9	49.2	50.3	51.3	51.3	51.2
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

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. MKD--Macedonian denar. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. 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

Ratings Score Snapshot	
Key rating factors	
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Fiscal assessment: flexibility and performance	3
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Monetary assessment	4

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

- 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Global Sovereign Rating Trends 2019, Jan. 14, 2019
- Sovereign Risk Indicators, Dec. 13, 2018. An interactive version is also available at http://www.spratings.com/sri
- What's In A Name? The Rating Implications For The Newly-Named Republic Of North Macedonia, Jan. 30, 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

Macedonia

Sovereign Credit Rating	BB-/Stable/B
Transfer & Convertibility Assessment	BB
Senior Unsecured	BB-

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search 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.