Research Update:

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

February 19, 2021

Overview

- We expect North Macedonia's economy to expand by 3.6% in 2021 after its pandemic-induced contraction last year.
- We project current account and fiscal deficits to narrow gradually over 2021-2024 and net government debt to rise to about 57% of GDP--around 15 percentage points above pre-pandemic levels.
- We are affirming our 'BB-/B' sovereign credit ratings on North Macedonia. The outlook is stable.

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Rating Action

On Feb. 19, 2021, 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 reflects our expectation that North Macedonia's projected economic recovery will help rein in fiscal and external deficits over the coming year.

Upside scenario

We could raise the ratings if continued reforms strengthened the sovereign's institutional arrangements while preserving sustainable fiscal policies. North Macedonia's EU accession aspirations could remain an anchor for institutional improvements and structural reform progress.

Downside scenario

We could lower the ratings if fiscal and current account deficits are higher than we project over the next one-to-two years, coupled with a continuous rise in net government debt or the buildup of external stress. The ratings could also come under pressure if the domestic financial system stability were to weaken materially in a hypothetical scenario of sustained asset quality deterioration and persistent deposit conversion to foreign currency.

Rationale

We expect North Macedonia will weather the pandemic-induced shock to its economy, as well as its external and fiscal metrics. To mitigate the impact of the containment measures and the reduced foreign demand for the country's exports, the government has deployed substantial stimulus to preserve employment and productive capacity in the country's economy. As a result, net general government debt will increase to 53% of GDP in 2021 from 41% in 2019.

We expect North Macedonia's economic growth to accelerate over 2021, particularly through public investment spending, private consumption, and recovering exports. The long-term growth outlook underpins our expectation that debt accumulation will slow to still-moderate levels over the coming two-to-three years. At the same time, access to funding from official and market sources underpin the ratings.

Our ratings on North Macedonia remain constrained by our view of the country's comparably low income levels; still-developing institutional settings, despite recent improvements; and monetary policy flexibility that is limited by the fixed exchange-rate regime.

Institutional and economic profile: Growth is set to resume in 2021

- We project that North Macedonia's economy will expand by 3.6% in 2021 after contracting by over 4% in 2020.
- The Bulgarian veto blocked the start of North Macedonia's EU accession talks in late 2020.
- Nonetheless, we think that the Social Democratic Union of Macedonia (SDSM)-led government will keep its Euro-Atlantic orientation.

We estimate that North Macedonia's economy contracted by 4.4% in 2020. After the 15% decline in second-quarter 2020, the deepest on record, we expect that the economy gradually recovered toward the end of 2020. Short-term indicators point to a very moderate contraction, if any, in the fourth quarter. In December, industrial production recorded the first positive monthly growth rate since February. North Macedonia is integrated in global supply chains, especially in the auto sector, and less reliant on the services sector--for example tourism--than regional peers. This integration, along with the impact of domestic containment measures, explains the pandemic's significant impact in spring 2020 through the trade channel.

We expect that the revival of the global auto sector over the past few months will underpin North Macedonia's economy recovery in 2021. We project 3.6% real GDP growth this year, but the country's economic perspectives depend on developments in key trading partners--for example, Germany accounts for about 50% of the country's exports.

At the same time, domestic demand will underpin growth in 2021. The government's fiscal stimulus of around 4% of GDP in 2020, in various sets of support measures, helped preserve employment and cushion the pandemic's economic impact. We expect that support measures will gradually be withdrawn, depending on the recovery, or replaced by other measures such as the fifth support package announced in February 2021. Broadly constant employment and sound wage growth in 2020 are supporting disposable incomes and the recovery of private consumption into 2021. Conversely, private consumption suffered notably in 2020 through declining worker remittances from abroad. We estimate private transfers to have declined by 20%-25% in 2020 due to adverse economic developments in the workers' (mostly European) host countries and travel restrictions.

We expect sizable government infrastructure investment to fuel growth over 2021-2024. Public investment will be one focus of the SDSM-led government formed in fall 2020. This aims, for example, at improving North Macedonia's physical infrastructure in transport, health, and education, and a total of €3.2 billion (almost 30% of 2021 GDP) is projected for capital investment from 2021-2025. In that regard, we note the government's efforts to improve the execution of capital expenditure plans.

Other domestic policy priorities include ensuring fiscal sustainability and implementing growth-supportive structural reforms. We note the importance of preserving North Macedonia's competitiveness in the context of rising labor costs and falling productivity in 2020. We view positively the government's sustained efforts to attract foreign direct investment (FDI) into the free economic zones, which it has expanded in recent years and have boosted the country's goods exports. Nevertheless, the economic structure remains fairly basic, with a prevalence of lower-value-added goods exports. Companies in the free economic zones are concentrated in the electronics and auto sectors, but a large proportion of inputs are still imported, rather than sourced domestically, which limits the free zones' wider integration into the domestic economy.

The government's foreign policy priorities received a setback when Bulgaria vetoed the negotiating framework and effectively blocked the start of EU accession talks late last year. We do not think this will change the Euro-Atlantic course of North Macedonia, but disappointment with recurring roadblocks despite the country's efforts in recent years (among others, the change of name to North Macedonia following the Prespa agreement with Greece to resolve the long-standing name dispute) could tilt foreign policy sentiment in the population.

At the same time, domestic political polarization between SDSM and nationalist VMRO-DPMNE remains high. Close election outcomes have occurred many times, including 2020, and often resulted in a parliamentary gridlock, with neither side easily securing a working majority. However, SDSM and the ethnic Albanian party DUI agreed on continuing their coalition government. Despite reforms in recent years, we think North Macedonia's institutions have shortcomings, which the government will aim to address. If EU accession negotiations were to open, this could be an important anchor for these reforms.

Flexibility and performance profile: Government debt is inching upward, following the pandemic-induced surge

- North Macedonia's fiscal deficits will average almost 4% in 2021-2024, consequently raising net general government debt to 57% of GDP by 2024.
- The recent widening of the current account deficit will reverse over the forecast horizon through 2024.
- We expect the peg of the Macedonian denar to the euro to continue.

North Macedonia's general government deficit widened to 8.1% of GDP in 2020 due to the effect of automatic stabilizers and fiscal measures in response to the pandemic. These comprised support to affected sectors, social security contribution subsidies to preserve employment, employment support to affected companies, and were accompanied by an accommodative monetary policy stance. For 2021, we expect the general government deficit to narrow to 4.9% of GDP and then further to 3.1% by 2024. Our forecast assumes deficits will decrease more gradually compared to the government's projections, which reflects our lower economic growth estimate.

We understand that the government aims to strengthen the fiscal framework. The government adopted the tax system reform strategy in December 2020, aiming for, among other goals, improving revenue collection and ultimately at supporting economic growth. The Organic Budget Law is in the legislative process and contains, among other provisions, the introduction of fiscal rules (which in essence mirror the eurozone's Maastricht criteria), and establishing a fiscal council. We also understand that improving revenue collection plays an important role in the government's consolidation plans, as revenue in relation to GDP lags that of higher-income European peers.

North Macedonia has significantly dipped into its fiscal space in 2020 and net general government debt is rising substantially to 53% of GDP in 2021 from 41% in 2019. With our projection of an average increase in net debt of over 4% in 2021-2024, net debt to GDP will gradually increase to 57% of GDP by 2024. This underlines that some of the pre-pandemic fiscal buffers have eroded. In 2020, the deficit was partially financed with international financial institutions facilities, such as from the IMF's Rapid Financing Instrument and an EU Macro-Financial Assistance facility. North Macedonia also issued a €700 million Eurobond in June 2020.

We estimate that the current account deficit widened to 3.7% of GDP in 2020. While exports declined broadly in tandem with imports, we expect remittances to have dropped by 20%-25% in 2020. In 2021-2024, we expect the current account deficit to narrow, particularly as exports recover in line with global auto demand, and private transfers increase. Government external borrowing partly replaced private external inflows in 2020. We project narrow net external debt to have increased to 29% of current account receipts in 2020 from 23% in 2019, and expect it to average 23% over our 2021-2024 forecast horizon.

In mid-August, the regulator revoked a license from a small domestic bank, Eurostandard. We understand that the bank had been vulnerable and undercapitalized. Its share in total domestic credit and deposits was small at below 2% and the license withdrawal did not have any systemic repercussions. The government is not involved in its resolution, and the deposit guarantee fund will assume insured deposit payouts with no government budget involvement. However, we understand that parties adversely affected by the license withdrawal voiced concerns in the media regarding banking sector surveillance and performance. While this was refuted by relevant authorities and international observers (such as the IMF) in North Macedonia, these episodes highlight the importance of maintaining trust in banking sector and exchange rate stability to avoid sudden volatility in deposits. There were some deposit withdrawals and conversions to foreign currencies briefly throughout April 2020 and some withdrawals following the Eurostandard bank license revocation. However, the overall rise in the deposit base in 2020 underpins that confidence was maintained.

In our view, North Macedonia's banking system is stable, but asset quality will likely weaken once the currently granted regulatory flexibility expires. However, the nonperforming-loan ratio was low at 3.4% as of third-quarter 2020. At year-end 2020, central bank reserves were 3% higher from year-end 2019, reflecting foreign borrowing.

We anticipate inflation will remain low, but increase to 1.7% by 2024, slightly above our projections for the eurozone.

We expect the pegged denar-euro exchange rate to continue for the foreseeable future. The absence of large-scale portfolio flows into North Macedonia somewhat relieves immediate risks related to the weaker outlook for remittances and FDI. Our baseline expectation is that there will be no large-scale resident conversion to foreign currencies, so the exchange rate will remain intact. The National Bank of the Republic of North Macedonia also recently agreed a €400 million repo line with the European Central Bank, which could be deployed in a downside scenario but has not been used so far.

Key Statistics

Table 1

North Macedonia--Selected Indicators

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Economic indicators (%)										
Nominal GDP (bil. LC)	559	595	618	661	689	668	706	745	785	826
Nominal GDP (bil. $)	10	11	11	13	13	12	14	15	15	16
GDP per capita (000s $)	4.9	5.2	5.5	6.1	6.0	5.9	6.6	7.0	7.3	7.7
Real GDP growth	3.9	2.8	1.1	2.9	3.2	(4.4)	3.6	3.5	3.3	3.2
Real GDP per capita growth	3.7	2.7	1.0	2.8	3.1	(4.5)	3.5	3.4	3.2	3.1
Real investment growth	8.3	12.5	(2.2)	1.7	9.5	(9.9)	8.0	3.9	4.0	3.6
Investment/GDP	30.4	32.5	32.3	32.3	34.5	32.0	33.4	33.6	33.9	34.1
Savings/GDP	28.5	29.6	31.4	32.2	31.2	28.3	31.0	31.7	32.1	32.4
Exports/GDP	48.7	50.7	55.1	60.4	62.3	56.6	61.4	62.3	63.2	64.2
Real exports growth	8.5	9.1	8.3	12.8	7.2	(11)	13.5	5.0	4.8	5.0
Unemployment rate	26.1	23.7	22.4	20.7	17.3	16.7	16.5	16.3	16.1	16.0
External indicators (%)										
Current account balance/GDP	(1.9)	(2.9)	(0.9)	(0.1)	(3.3)	(3.7)	(2.4)	(1.9)	(1.7)	(1.7)
Current account balance/CARs	(2.8)	(4.2)	(1.1)	(0.2)	(4.1)	(5.2)	(3.0)	(2.4)	(2.2)	(2.1)
CARs/GDP	68.8	69.9	75.1	79.5	80.4	70.9	78.2	79.7	80.7	81.9
Trade balance/GDP	(20.1)	(18.8)	(17.8)	(16.2)	(17.6)	(16.1)	(17.5)	(17.1)	(16.9)	(16.5)
Net FDI/GDP	2.3	3.3	1.8	5.6	3.2	1.6	2.3	2.5	2.5	2.5
Net portfolio equity inflow/GDP	(0.4)	(0.2)	(0.4)	(0.8)	(0.0)	(0.1)	(0.7)	(0.7)	(0.7)	(0.7)
Gross external financing needs/CARs plus usable reserves	108.3	109.9	106.4	109.4	112.1	115.4	113.0	110.8	109.2	108.1
Narrow net external debt/CARs	26.9	28.3	32.6	24.3	23.2	29.3	25.4	24.2	22.5	20.8
Narrow net external debt/CAPs	26.1	27.1	32.2	24.3	22.2	27.9	24.6	23.6	22.0	20.4
Net external liabilities/CARs	80.2	78.8	82.2	68.6	71.6	87.7	74.2	71.2	68.7	66.3
Net external liabilities/CAPs	78.0	75.7	81.3	68.5	68.8	83.3	72.0	69.5	67.3	65.0
Short-term external debt by remaining maturity/CARs	27.1	21.3	20.3	20.2	20.7	25.2	22.1	21.0	20.5	19.8
Usable reserves/CAPs (months)	2.3	1.6	1.7	1.2	1.3	1.5	1.3	1.3	1.5	1.5

Table 1

North Macedonia--Selected Indicators (cont.)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Usable reserves (mil. $)	1,055	1,198	1,010	1,153	1,136	1,155	1,318	1,526	1,692	1,876
Fiscal indicators (general government; %)										
Balance/GDP	(3.4)	(2.7)	(2.8)	(1.1)	(2.2)	(8.1)	(4.9)	(3.8)	(3.4)	(3.1)
Change in net debt/GDP	5.0	4.4	3.2	1.6	3.7	7.3	5.9	4.8	4.1	3.4
Primary balance/GDP	(2.3)	(1.5)	(1.5)	0.1	(1.0)	(6.8)	(3.5)	(2.2)	(1.8)	(1.3)
Revenue/GDP	31.0	30.6	31.0	30.4	31.5	30.4	32.1	30.8	30.5	30.5
Expenditures/GDP	34.4	33.2	33.8	31.5	33.7	38.5	37.0	34.6	33.9	33.6
Interest/revenues	3.8	3.8	4.4	3.9	3.7	4.1	4.4	5.0	5.4	5.8
Debt/GDP	41.6	44.7	44.4	45.8	46.9	57.1	59.9	61.6	62.6	62.9
Debt/revenues	134.3	146.2	143.3	150.8	148.8	187.8	186.6	199.9	205.2	206.2
Net debt/GDP	36.4	38.6	40.4	39.3	41.4	50.0	53.2	55.2	56.6	57.2
Liquid assets/GDP	5.2	6.1	4.0	6.5	5.5	7.1	6.7	6.4	6.0	5.7
Monetary indicators (%)										
CPI growth	(0.3)	(0.2)	1.4	1.5	0.8	1.2	1.5	1.5	1.7	1.7
GDP deflator growth	2.0	3.5	2.8	3.9	1.1	1.3	2.0	2.0	2.0	2.0
Exchange rate, year-end (LC/$)	56.37	58.33	51.27	53.69	54.95	50.24	51.29	51.29	51.29	51.29
Banks' claims on resident non-gov't sector growth	9.6	0.2	5.4	7.3	6.4	4.8	6.0	6.0	6.0	6.0
Banks' claims on resident non-gov't sector/GDP	51.1	48.1	48.8	48.9	49.9	54.0	54.2	54.4	54.7	55.1
Foreign currency share of claims by banks on residents	44.8	43.8	41.7	40.3	41.2	41.2	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	41.2	41.6	40.9	40.0	38.4	39.7	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(0.3)	1.1	(0.5)	1.4	(1.7)	N/A	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."
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, external political developments 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. Additionally, there are downside risks from a hypothetical scenario of persistent deposit withdrawals and conversions to FX. This is not fully captured in the indicative rating level.
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, Feb. 3, 2021
- Sovereign Ratings History, Feb. 3, 2021
- Sovereign Ratings Score Snapshot, Feb. 2, 2021
- Global Sovereign Rating Trends 2021: Mounting Debt And Uncertainty Underpin A Negative Outlook Bias, Jan. 27, 2021
- Sovereign Risk Indicators, Dec. 14, 2020. A free interactive version is available at http://www.spratings.com/sri
- 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-