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Ratings

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Research Update:

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

August 19, 2022

Overview

- Due to the indirect effects of the Russia-Ukraine conflict, we expect North Macedonia's real GDP growth to slow to 1.5% in 2022 while its fiscal and external deficits widen.
- North Macedonia's international reserves have declined by 11% since December 2021 because of valuation effects, government debt payments, and the central bank providing additional foreign currency to commercial banks to satisfy increased import demand stemming from higher energy prices.
- Although reserves could come under pressure again later this year, we expect this to gradually subside as energy prices moderate--as we forecast they will--from 2023 onward. We also believe North Macedonia will be able to access IMF financing if its balance of payments performance proves weaker than expected.
- We affirmed our 'BB-/B' sovereign credit ratings on North Macedonia. The outlook is stable.

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Rating Action

On Aug. 19, 2022, 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 view that multiple risks arising from the Russia-Ukraine conflict over the next 12 months are counterbalanced by North Macedonia's proactive policymaking as well as its moderate government debt and contained interest costs. We project North Macedonia's general government interest payments will amount to around 5% of government revenues over the next four years, which is comparatively modest in a global context.

Downside scenario

We could lower the ratings if North Macedonia's balance of payments performance proved weaker than we expect, leading to a higher depletion of international reserves and possibly presenting risks to the stability of the denar peg. This scenario could entail the additional risk that domestic residents increasingly convert deposits from local into foreign currency, but this is not our baseline scenario. The ratings could also come under pressure if fiscal deficits worsened beyond our expectations in the medium term, leading to a protracted build-up of government leverage in contrast to our current projection of net general government debt stabilizing at close to 53% of GDP through 2025.

Upside scenario

We could raise the ratings if structural reform implementation strengthened North Macedonia's institutional settings while its fiscal performance improved, with net general government debt trending down, alongside robust GDP growth.

Rationale

Our base case is that North Macedonia will weather the macroeconomic headwinds from the Ukraine-Russia conflict. This includes the economic uncertainties associated with the German economic slowdown, given that roughly half of North Macedonia's goods exports go directly to Germany. Our base case also factors in the pressures associated with rising energy prices, which led to a significant widening of the current account deficit to 13.4% of GDP in the first quarter of 2022.

Valuation effects, external debt payments, energy-related import pressures, and a lack of government external borrowing have led North Macedonia to draw down on its gross foreign exchange (FX) reserves; these fell to €3.20 billion in July (roughly 3.6 months of imports) from €3.64 billion at end-2021.

Still, we currently do not expect these elevated balance of payments pressures will undermine the stability of the denar-euro peg. This is driven by our assumption that:

- Investment inflows will remain strong. This is evidenced by a net FDI inflow of €100 million in the first quarter of this year.
- The government plans to issue Eurobonds in the coming months to fund the fiscal deficit, and this will likely support foreign reserves.
- IMF and broader IFI support will be likely be forthcoming. North Macedonia requested an IMF Precautionary and Liquidity Line (PLL) in April, which is currently pending staff approval.

Overall, our ratings on North Macedonia remain constrained by the weak yet improving institutional framework, comparatively low GDP per capita, increasing government debt predominantly denominated in foreign currency, and limited monetary flexibility due to the denar peg.

The ratings are supported by what we view as a highly capitalized banking sector, as well as still-moderate net general government debt levels and contained costs of servicing it. We forecast annual government interest expenditure at about 5% of government revenues, which we view as reasonably modest in an emerging market comparison.

Institutional and economic profile: Formal EU accession talks have finally begun, but the short-term economic outlook has deteriorated

- Growth will slow significantly in 2022 due to a range of factors mostly stemming from the Russia-Ukraine conflict, but we expect recovery to strengthen from 2023.
- North Macedonia's direct trade and financial linkages to Russia and Ukraine are limited, but inflationary and other indirect factors will have an impact.
- EU accession talks have begun but the process remains fraught with hurdles.

We forecast North Macedonia's real GDP growth to slow to 1.5% in 2022, from 4.0% in 2021, on lower external demand (primarily from the EU) aggravated by the indirect effects of the Russia-Ukraine conflict--primarily in the form of higher energy prices. We also think weaker domestic household consumption due to high inflation and tighter credit conditions will contribute to weaker growth this year. In our view this will be partially mitigated by government consumption and investment growth stemming from higher government spending and investment. Downside risks to our forecast include potential political instability from a remote chance of snap elections and an escalation in the Ukraine-Russia conflict that could cause commodity prices to surge even further. From 2023 onward, we expect growth to strengthen and average 2.7%.

High-frequency indicators including retail trade and business surveys support our view that economic momentum has decelerated in recent months. In addition, monthly average gross wages increased by 9% in May 2022 compared to the previous year, mainly due to an increase in the minimum wage. However, real wages growth remains negative because of inflation, which will weigh on consumer demand.

North Macedonia's trade and financial links with Russia and Ukraine are limited. Nonetheless, it has some energy exposure to Russia. Most natural gas imports come from Russia, but this only comprises about a 10% share of North Macedonia's total energy mix. Moreover, approximately 8% of oil imports originate from Russia. Despite Russia halting gas supplies to Bulgaria, North Macedonia continues to receive gas from Russia via pipelines in Bulgaria.

Accession talks between the EU and North Macedonia started in July 2022. Progress hinges on parliament's approval of a French-backed proposal that was created to encourage Bulgaria to withdraw its veto on North Macedonia's EU membership bid. Under the proposal, North Macedonia must amend its constitution to acknowledge a Bulgarian minority, among other measures. As a result, the first of two intergovernmental conferences (IGC) between North Macedonia and EU have been held. The second IGC will only be held once North Macedonia's constitution is changed in accordance with the French-backed proposal. Under Macedonian law, constitutional amendments require 80 out of 120 votes in favor for any proposal to pass. Given the political polarisation and the number of votes required for the French proposal to pass, we don't expect the second IGC to be held soon. Bulgaria could also again block North Macedonia's bid for EU membership. Nevertheless, we still consider that the country's EU membership bid should serve as an anchor for structural and institutional developments over the longer term, supporting its economic prospects.

Flexibility and performance profile: Sizable twin external and fiscal deficits in 2022

- We expect the general government deficit to remain elevated at 5.1% of GDP in 2022, followed by gradual fiscal consolidation over the next four years.

- We forecast that North Macedonia will post a current account deficit of 8.3% of GDP in 2022, the highest since 2008, owing to higher costs of energy imports.
- International reserves have come under pressure since the beginning of the year, but we expect buffers to be primarily replenished by external borrowing and incoming net FDI inflows. North Macedonia could get additional financing from the IMF if balance-of-payments pressures increase.

The government recently approved a supplementary budget that raised the fiscal deficit to 5.3% of GDP in 2022, from 4.2% in the initial budget. Extra spending has been earmarked for public sector wages, agricultural sector subsidies, higher pensions, and liquidity support for companies. Targeted support has also been offered to help citizens cope with increased living costs. Given the new budget and the government's record of under-use of budgeted capex, we expect the fiscal deficit to remain elevated at 5.1% of GDP in 2022--slightly down from 5.4% in 2021. The budget deficit will be financed via a mix of domestic and foreign borrowing (Eurobonds) as well as previously accumulated liquidity.

Thereafter, we expect the general government deficit to average approximately 3.2% through to 2025. The government's fiscal consolidation efforts will continue to face challenges including the economy's large informal sector and the indirect effects of the Russia-Ukraine conflict. We project net general government debt to rise from 52.6% of GDP in 2022 and stabilize by 2025.

We also note that roughly 75% of government debt is denominated in foreign currency, which could present risks particularly in a scenario of the pegged exchange rate regime coming under increasing pressure, but this is not our baseline. We consider that the adoption of the Organic Budget Law, which outlines a set of fiscal rules (similar to the eurozone's Maastricht criteria) and the establishment of an independent fiscal council should help North Macedonia's budgetary consolidation. We also note that North Macedonia's costs of servicing government debt remain contained and we expect will average around 5% of government revenues over the next four years, significantly lower than most emerging markets.

North Macedonia's exports to Germany accounted for 47% of total exports in 2021. It is also a net energy and food importer. Given our expectations of an economic slowdown in Germany and elevated hydrocarbon prices in 2022 and 2023, we expect North Macedonia's current account deficit to widen significantly to 8.3% of GDP in 2022, from 3.4% in 2021. After 2022, we expect the current account deficit to decline gradually, averaging 4% of GDP until 2025.

The 2022 external deficit will be financed by a mix of foreign reserves depletion, net foreign direct investment (FDI) inflows, and external government borrowing. Thereafter, net FDI inflows will once again become the main component of financing future external deficits. We expect net FDI to rebound and average 3% of GDP through to 2025 following a pandemic-related drop in investment. But changes in the supply chain represent a risk, particularly in the automotive sector as it transitions away from the combustion engine, at least in Europe. Nevertheless, the government is aiming to preserve the country's FDI attractiveness. For instance, it recently announced the opening of its first high-tech economic zone--Skopje III--which aims to be a national hub for new technologies and clean manufacturing. The zone offers incentives similar to other free economic zones, including a 10-year holiday on corporate and personal income tax. Currently, companies operating in North Macedonia's free economic zones are focused on the electronic and auto sectors, and a large proportion of inputs are still imported rather than sourced domestically, which limits the free zones' wider integration into the domestic economy.

We anticipate no changes to the pegged denar-euro exchange rate regime. However, the central bank's foreign reserves have come under pressure since the beginning of the year due to increases in the energy import bill and decreases in the values of security holdings. Consequently, foreign reserves have decreased by €446 million since the end of 2021 to €3.2 billion in July. We expect pressure on the National Bank of the Republic of North Macedonia's (NBRNM) foreign reserves to emerge again later in the year as winter begins but then to gradually subside as energy prices moderate from the current highs in 2023-2024.

We deduct from our calculation of usable reserves the FX held as part of bank's required reserves, and an amount equivalent to the monetary base, because we believe the latter would be required to defend the peg. To mitigate the issue, the authorities have requested a two-year PLL from the IMF and negotiations are ongoing. Additionally, we consider that North Macedonia benefits from connections with international financial institutions and access to their financing facilities. For example, the EBRD recently granted a €100 million liquidity support line in the form of loan to the national energy company JSC Elektrani na Severna Makedonija. Lastly, we expect the authorities to return to the Eurobond market later this year.

Inflation has increased in recent months, primarily due to higher energy and food prices, to 16.0% in July from 6.7% in January, and is now at its highest since June 1995. Similarly, core inflation increased to a new peak of 7.2%, showing that inflation is more entrenched. We expect inflation to average 14% this year and decline thereafter as price pressures ease. Lastly, in line with the European Central Bank's monetary policy tightening, the NBRNM has hiked its policy rate by a cumulative 125 basis points so far this year.

North Macedonia's financial sector linkages with Russia are limited and the authorities did not have to intervene to manage the fallout of sanctions on Russian bank subsidiaries. This set North Macedonia apart from countries like Slovenia, Croatia, and Bosnia and Herzegovina. Pressures within the banking system emerged nonetheless, with a short-lived episode of deposit withdrawals in March. This has since subsided. That said, the euroization of deposits has edged up with the share of deposits in foreign currencies rising from 42.8% in December 2021 to roughly 45.4% in June 2022. In response, the NBRM has reduced the reserve requirements (RRs) in denar to 5% and increased RRs in foreign currency to 18%. Moreover, a counter cyclical buffer of 0.5% has been introduced, which comes into effect in August 2023. We do not expect significant additional deposit withdrawals or their conversion to foreign currency in our current base case. The nonperforming loans ratio remains low at 3%, and the capital adequacy ratio is stable at 17%.

Key Statistics

Table 1

North Macedonia Selected Indicators

Mil. MKD	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Economic indicators (%)										
Nominal GDP (bil. MKD)	595	618	661	693	656	723	807	871	923	978
Nominal GDP (bil. $)	11	11	13	13	12	14	14	16	17	19
GDP per capita (000s $)	5.2	5.5	6.1	6.1	5.8	6.7	6.9	7.7	8.4	9.0
Real GDP growth	2.8	1.1	2.9	3.9	(6.1)	4.0	1.5	2.2	2.8	3.1
Real GDP per capita growth	2.7	1.0	2.8	3.8	(6.1)	4.3	1.5	2.2	2.8	3.1
Real investment growth	12.5	(2.2)	1.7	8.7	(16.1)	9.2	7.0	5.0	3.1	3.2
Investment/GDP	32.5	32.3	32.3	34.3	29.0	33.8	35.0	35.4	35.2	34.9

Table 1

North Macedonia Selected Indicators (cont.)

Mil. MKD	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Savings/GDP	29.6	31.4	32.2	31.0	25.6	30.4	26.7	29.9	31.4	31.8
Exports/GDP	50.7	55.1	60.4	62.4	58.9	65.9	74.1	80.7	82.8	86.6
Real exports growth	9.1	8.3	12.8	8.9	(10.9)	12.3	9.6	7.8	6.8	6.8
Unemployment rate	23.7	22.4	20.7	17.3	16.4	15.7	14.5	14.0	13.6	13.2
External indicators (%)										
Current account balance/GDP	(2.9)	(0.9)	(0.1)	(3.3)	(3.4)	(3.4)	(8.3)	(5.5)	(3.8)	(3.2)
Current account balance/CARs	(4.2)	(1.1)	(0.2)	(4.1)	(4.6)	(4.0)	(9.1)	(5.5)	(3.7)	(3.0)
CARs/GDP	69.9	75.1	79.5	80.1	75.4	85.3	91.3	99.8	102.8	106.2
Trade balance/GDP	(18.8)	(17.8)	(16.2)	(17.3)	(17.0)	(20.1)	(23.0)	(23.9)	(23.5)	(23.0)
Net FDI/GDP	3.3	1.8	5.6	3.2	1.4	3.7	2.8	3.0	3.0	3.0
Net portfolio equity inflow/GDP	(0.2)	(0.4)	(0.8)	(0.0)	(0.5)	(0.4)	(0.3)	(0.3)	(0.3)	(0.3)
Gross external financing needs/CARs plus usable reserves	109.9	106.4	109.4	112.0	114.4	113.6	117.6	114.9	113.5	112.1
Narrow net external debt/CARs	28.2	32.6	24.3	23.1	33.6	26.6	33.7	31.5	30.2	29.0
Narrow net external debt/CAPs	27.1	32.3	24.3	22.2	32.1	25.5	30.9	29.9	29.2	28.2
Net external liabilities/CARs	78.8	82.2	68.6	71.6	92.8	70.0	72.6	64.9	61.1	58.2
Net external liabilities/CAPs	75.6	81.3	68.5	68.7	88.8	67.3	66.6	61.5	58.9	56.5
Short-term external debt by remaining maturity/CARs	21.3	20.3	20.2	20.7	24.1	20.6	20.0	16.6	16.6	16.8
Usable reserves/CAPs (months)	1.6	1.7	1.2	1.3	1.4	1.1	1.1	0.7	0.7	0.8
Usable reserves (mil. $)	1,201	1,009	1,153	1,137	1,153	1,267	1,013	1,061	1,346	1,715
Fiscal indicators (general government; %)										
Balance/GDP	(2.7)	(2.8)	(1.1)	(2.1)	(8.3)	(5.4)	(5.1)	(4.0)	(3.4)	(2.4)
Change in net debt/GDP	4.3	3.2	1.6	3.5	7.7	5.3	6.4	4.6	3.2	2.2
Primary balance/GDP	(1.5)	(1.5)	0.1	(1.0)	(7.1)	(4.1)	(3.7)	(2.4)	(1.6)	(0.6)
Revenue/GDP	30.6	31.0	30.4	31.4	30.5	32.3	32.0	31.3	30.7	30.7
Expenditures/GDP	33.2	33.8	31.5	33.5	38.9	37.7	37.1	35.3	34.1	33.1
Interest/revenues	3.8	4.4	3.9	3.7	4.0	3.9	4.4	5.2	5.8	5.8
Debt/GDP	44.7	44.4	45.8	46.5	58.2	58.2	58.6	58.9	58.8	57.7
Debt/revenues	146.2	143.3	150.8	148.3	190.5	180.4	183.1	188.2	191.6	187.9
Net debt/GDP	38.6	40.4	39.3	41.0	51.0	51.6	52.6	53.4	53.6	52.8
Liquid assets/GDP	6.1	4.0	6.5	5.5	7.2	6.7	6.0	5.5	5.2	4.9

Table 1

North Macedonia Selected Indicators (cont.)

Mil. MKD	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Monetary indicators (%)										
CPI growth	(0.2)	1.4	1.5	0.8	1.2	3.2	14.0	7.2	3.5	2.6
GDP deflator growth	3.5	2.8	3.9	0.9	0.9	6.1	10.0	5.6	3.0	2.8
Exchange rate, year-end (LC/$)	58.33	51.27	53.69	54.95	50.24	54.37	56.23	53.61	52.26	52.52
Banks' claims on resident non-gov't sector growth	0.2	5.4	7.3	6.4	4.8	8.3	6.0	6.0	6.0	6.0
Banks' claims on resident non-gov't sector/GDP	48.1	48.8	48.9	49.7	55.0	54.0	51.2	50.3	50.4	50.4
Foreign currency share of claims by banks on residents	43.8	41.7	40.3	41.2	41.2	40.3	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	41.6	40.9	40.0	38.4	39.7	42.8	N/A	N/A	N/A	N/A
Real effective exchange rate growth	1.1	(0.5)	1.4	(1.7)	1.9	1.1	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)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

Ratings Score Snapshot North Macedonia

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 perSelected Indicators in table 1.

Table 2

Ratings Score Snapshot North Macedonia (cont.)

Key rating factors	Score	Explanation
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. Over 75% of the gross government debt is denominated in foreign currency.
Monetary assessment	4	The North Macedonian denar is pegged to the euro. Furthermore, The 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. Most importantly, we do not believe the indicative rating full captures the potential economic and political downside risks arising from the Russia-Ukraine conflict.
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

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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 Risk Indicators, July 11, 2022, An interactive version is available at www spratings com/SRI
- Sovereign Ratings History, Aug. 4, 2022
- Sovereign Ratings List, Aug. 4, 2022
- Global Credit Conditions Q3 2022: Resurfacing Credit Headwinds, June 30, 2022
- 2021 Annual Global Sovereign Default And Rating Transition Study, May 4, 2022

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
North Macedonia	
Senior Unsecured	BB-

69-33-999-225; or Stockholm (46) 8-440-5914