S&P Global Ratings

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Research Update:

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

July 28, 2023

Overview

- North Macedonia's real GDP will expand by a moderate 2.1% this year and gradually improve thereafter, averaging 2.7% in 2023-2026, as growth in its major export markets begins to recover.
- We anticipate a slower pace of fiscal consolidation, but net general government debt will remain broadly stable over the next few years, averaging 53% of GDP in 2023-2026.
- We affirmed our 'BB-/B' sovereign credit ratings on North Macedonia. The outlook is stable.

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Rating Action

On July 28, 2023, S&P Global Ratings affirmed its 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on North Macedonia. The outlook is stable.

Outlook

The stable outlook reflects our assessment that potential risks stemming from the Russia-Ukraine conflict are largely mitigated by North Macedonia's growth prospects, moderate government debt, and contained interest costs.

Upside scenario

We could raise the ratings if the country shows strong progress in implementing structural reforms, leading to an enhanced institutional framework. Additionally, positive triggers for an upgrade would include improved fiscal performance with a decreasing trend in net general government debt, as well as strong GDP growth.

Downside scenario

We could lower the ratings if the country's fiscal or external metrics significantly deteriorate, or we see a depletion of its foreign exchange reserves that pressures the de-facto peg to the euro. Furthermore, if fiscal deficits worsen substantially beyond our medium-term projections, it could pressure the ratings. This would be especially pertinent if there were a sharp increase in government leverage.

Rationale

Our ratings on North Macedonia are constrained by a weak but gradually improving institutional framework, relatively low GDP per capita, high government foreign exchange debt, and limited monetary flexibility due to the denar's peg to the euro.

Nevertheless, our ratings are supported by moderate net government and external debt levels, the strong outlook for net foreign direct investment (FDI) inflows, and a stable banking sector.

Institutional and economic profile: Formal EU accession talks support long-term prospects, but the short-term economic outlook remains constrained

- North Macedonia's economy is set to expand a moderate 2.1% in 2023 and 3.0% on average during 2024-2026.
- Political stability has improved since the government increased its parliamentary majority but elections scheduled for next year could shift the political landscape.
- EU accession talks continue to hinge on the adoption of a proposal, backed by France, to recognize the country's Bulgarian minority.

We anticipate that real GDP will expand a moderate 2.1% in 2023, reflecting a similar trajectory to the previous year. This is primarily attributed to low external demand, particularly from the EU, which is economically strained by the repercussions of the Russia-Ukraine conflict. Growth this year will also be hampered by reduced domestic household consumption, amid elevated inflation and tighter credit conditions. Nevertheless, the inflow of remittances from Macedonians employed overseas will support household consumption, and significantly sustain growth. Additionally, investments, including government initiatives like the Corridor 8 and 10d highway projects, with a total value of €1.3 billion, will help boost the economy. Looking beyond 2023, we anticipate a mild improvement in growth, reaching approximately 3% annually, as the indirect effects of the Russia-Ukraine conflict gradually subside, and external demand picks up.

North Macedonia maintains limited direct trade and financial connections with Russia and Ukraine, despite having some exposure to Russia in the energy sector. Most natural gas imports are sourced from Russia, but they constitute only 10% of North Macedonia's overall energy composition. Furthermore, less than 1% of oil imports are sourced from Russia. Despite Russia's suspension of gas supplies to Bulgaria, North Macedonia continues to receive Russian gas through pipelines via Bulgaria.

The next parliamentary elections are due next year, which could change the political landscape. The previous elections, in July 2020, resulted in the formation of a coalition government led by the Social Democratic Union of Macedonia (SDSM). A key objective of the current administration is to advance toward EU membership. However, in February 2023, a government reshuffle was announced, leading to the Alliance for Albanians replacing the Alternative party in the coalition. This reshuffle bolstered the ruling coalition's parliamentary majority to 68 seats of the 120, from

60. We believe that it has enhanced political stability and reduced the likelihood of early elections. Nonetheless, the country continues to grapple with long-standing political polarization, particularly between the SDSM and the opposition party, the Internal Macedonian Revolutionary Organization – Democratic Party for Macedonian National Unity (VMRO-DPMNE). This polarization has occasionally resulted in parliamentary obstructions, causing delays in the approval of legislation, and posing challenges to the country's institutional framework. North Macedonia's institutional framework is also marred by various deficiencies, including corruption. However, gradual progress has been made in recent years to address such issues.

Accession negotiations between North Macedonia and the EU formally began in July 2022. The progression of these talks hinges on parliament's endorsement of a France-backed proposal formed to encourage Bulgaria to withdraw its veto on North Macedonia's EU membership bid. According to the proposal, North Macedonia must enact constitutional amendments to acknowledge a Bulgarian minority, among other measures. As a result, the first of two intergovernmental conferences (IGC) between North Macedonia and the EU were held. The second IGC will only occur once North Macedonia's constitution is changed in accordance with the France-backed proposal. Under Macedonian legislation, constitutional amendments require at least 80 of 120 votes for a proposal to pass. Given the prevailing political polarization and the required vote count, the second IGC is unlikely to be held soon. Bulgaria could also block North Macedonia's bid for EU membership again. Nevertheless, we still consider the EU accession bid to serve as an anchor for structural and institutional developments over the medium term, supporting the country's economic prospects and helping alleviate its substantial emigration flows.

Flexibility and performance profile: Fiscal and external pressures are anticipated to persist throughout 2023-2026

- We expect a budget deficit averaging 3.5% of GDP over 2023-2026, versus our previous forecast of 3.2%.
- Nevertheless, net general government will remain stable, averaging 53% of GDP over 2023-2026.
- Despite forthcoming Eurobond redemptions, we expect foreign reserves to remain on a stable trajectory.

Given the government's track record of budget spending underutilization in recent years, we anticipate a budget deficit of 4.4% of GDP in 2023, which is consistent with last year's fiscal performance and slightly below the government's target of 4.6%. The authorities aim to boost revenue by streamlining preferential treatments on corporate, personal income, and value-added tax. In addition, the EU has provided €80 million of budget support in the form of a grant. On the expenditure side, subsidies to the state-owned electricity company will constitute 1.5% of GDP, with consumers currently protected from large tariff adjustments. In addition, the authorities are targeting a reduction in the government's operating costs through a decrease in expense such as electricity consumption, travel, and the hiring of external consultants, among others.

In line with previous years, the budget deficit will be financed with a mixture of domestic and foreign borrowing. This year, the authorities returned to the Eurobond market, issuing €500 million to pre-finance a €450 million Eurobond due in 2023. In November 2022, the authorities also obtained approval from the IMF for a two-year €530 million precautionary liquidity line (PLL), and have since secured a macro-financial assistance (MFA) package from the European Commission worth €100 million.

Over the long term, we expect a slower pace of fiscal consolidation as the government prioritizes its strategy aimed at promoting growth through infrastructure projects, such as the Corridor 8 and 10d highway project. As a result, the budget deficit will average 3.5% of GDP from 2023-2026, up from our previous forecast of 3.2%. Fiscal consolidation efforts face ongoing challenges, including the country's large informal sector, potential cost overruns in infrastructure projects, and the lingering effects of the Russia-Ukraine conflict (although notably less severe than in the past). Nevertheless, our projections indicate that net general government debt will remain broadly stable at about 53% of GDP in the next few years.

We note that about 75% of government debt is denominated in foreign currency, which could create downside risks if the pegged exchange rate regime comes under pressure--although this is not our baseline scenario. Strict adherence to the recently adopted 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 accelerate North Macedonia's fiscal consolidation efforts. We also note that despite tightening global financing conditions, North Macedonia's cost of servicing government debt remains contained and we expect it will average about 5% of government revenue over the next four years, which is lower than many peers.

North Macedonia heavily relies on Germany, which accounted for roughly 45% of total exports in 2022. It is also a net energy and food importer. Due to an economic slowdown in Germany and slightly elevated hydrocarbon prices this year, we expect the country's current account deficit to remain relatively wide, at about 3.7% of GDP, albeit down from 6.2% in 2022. We project a gradual narrowing of the deficit over time, averaging over 3.3% of GDP until 2026. The 2023 current account deficit will most likely be financed via a combination of channels that include net FDI inflows and external government borrowing (via Eurobonds, IMF program disbursements, and international financial institution loans).

In November 2022, the IMF approved a two-year €530 million PLL line requested earlier that year. The authorities plan to draw €265 million of the PLL funds and treat the remainder as precautionary--or available to be draw down if required. Given tightening financial conditions, the program will mainly help it meet forthcoming external and fiscal financing needs. Priorities under the PLL program include fiscal consolidation, reducing inflation, and protecting financial stability. In July, the European Commission also approved a €100 million MFA package in the form of loans. Disbursements from the MFA will be contingent upon the successful implementation of a broad range of structural reforms and a positive track record in the IMF program.

We expect net FDI will average roughly 3% of GDP through to 2026. But changes in global supply chains represent a risk, particularly in the auto sector as it transitions away from traditional combustion engines, at least in Europe. Nevertheless, the government is committed to maintaining the country's attractiveness for FDI and unveiled its first high-tech economic zone last year. Skopje III, which aims to become a national hub for new technologies and clean manufacturing, will offer similar incentives to other economic zones such as a 10-year holiday on corporate and personal income tax. Currently, companies operating within North Macedonia's free economic zones are primarily focused on the electronics and auto sectors. However, a significant portion of inputs are still imported rather than sourced domestically, which limits the integration of these free zones into the wider domestic economy.

We anticipate the pegged denar-euro exchange rate regime will be unchanged, despite a tough external environment. The central bank's foreign reserves shrank to €3.2 billion in May 2022 due to a high energy import bill and a decrease in securities holdings. However, reserves rebounded strongly to €4.2 billion as of June 2023, primarily attributed to external government borrowing and interventions by the central bank. Despite a Eurobond redemption due this year, we expect foreign reserves to be stable, supported by improving external conditions.

After peaking at nearly 20% in late 2022, inflation has gradually slowed, primarily driven by lower food and energy prices. It stood at 9.3% in June 2023 and we anticipate a further deceleration in the coming months given easing commodity prices and monetary policy tightening by the National Bank of the Republic of North Macedonia (NBRM)--in line with the European Central Bank. As a result, we project headline inflation will average about 9% this year and 4% in 2024. However, it is important to note that there are potential risks to the inflation outlook, particularly stemming from the tight labor market, which could push up prices.

North Macedonia's financial sector has limited links with Russia so the authorities did not need to intervene to manage the fallout from sanctions on Russian bank subsidiaries. This sets North Macedonia apart from neighboring countries like Slovenia, Croatia, and Bosnia and Herzegovina. Although pressures emerged within the banking system, leading to a brief episode of deposit withdrawals in March 2022, the euroization of deposits has decreased since then but remains above 40% of total stocks. The NBRM responded by adjusting reserve requirements in the past year, reducing them to 5% for the domestic currency and increasing them to 19% for foreign currency deposits. The sector's nonperforming loans remain low at 2.8% of total loans, and the capital adequacy ratio was stable at 18% in first-quarter 2023. As a result, the likelihood of contingent liabilities for the government arising from the financial sector remains reasonably low in the near term.

Key Statistics

Table 1

North Macedonia Selected Indicators

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Economic indicators (%)										
Nominal GDP (bil. LC)	618	661	693	669	720	795	876	928	984	1,042
Nominal GDP (bil. $)	11	13	13	12	14	14	15	17	18	20
GDP per capita (000s $)	5.5	6.1	6.1	6.0	6.7	7.4	8.3	9.1	10.0	10.8
Real GDP growth	1.1	2.9	3.9	(4.7)	3.9	2.1	2.1	2.8	3.1	3.1
Real GDP per capita growth	1.0	2.8	3.8	(4.6)	4.3	15.0	2.1	2.7	3.0	3.0
Real investment growth	(2.2)	1.7	9.5	(15.1)	0.9	15.0	5.0	3.1	3.2	3.2
Investment/GDP	32.3	32.3	34.3	29.9	32.3	35.0	34.4	34.1	33.9	33.7
Savings/GDP	31.7	32.5	31.3	27.0	29.3	28.8	30.6	30.4	30.8	31.2
Exports/GDP	55.1	60.4	62.4	57.8	66.2	74.9	77.9	77.7	79.1	80.2
Real exports growth	8.3	12.8	8.9	(10.9)	11.7	13.4	5.0	3.8	3.4	3.2
Unemployment rate	22.4	20.7	17.3	16.4	15.7	14.4	14.0	13.6	13.2	13.2
External indicators (%)										
Current account balance/GDP	(0.6)	0.1	(3.0)	(2.9)	(3.0)	(6.2)	(3.7)	(3.7)	(3.1)	(2.4)
Current account balance/CARs	(0.8)	0.2	(3.7)	(3.9)	(3.5)	(6.4)	(3.8)	(3.8)	(3.2)	(2.5)
CARs/GDP	75.4	79.8	80.4	74.3	85.9	96.3	97.7	98.6	99.0	98.6
Trade balance/GDP	(17.8)	(16.2)	(17.3)	(16.7)	(20.2)	(26.8)	(26.0)	(25.4)	(24.6)	(23.8)
Net FDI/GDP	1.8	5.6	3.2	1.4	3.3	5.2	3.0	3.0	3.0	3.0

Table 1

North Macedonia Selected Indicators (cont.)

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Net portfolio equity inflow/GDP	(0.4)	(0.8)	(0.0)	(0.5)	(0.4)	(0.8)	(0.3)	(0.3)	(0.3)	(0.3)
Gross external financing needs/CARs plus usable reserves	106.0	109.1	111.7	113.8	113.1	115.2	114.9	114.3	112.8	112.0
Narrow net external debt/CARs	32.5	24.3	23.0	33.4	26.4	27.1	27.1	27.4	25.8	24.8
Narrow net external debt/CAPs	32.3	24.3	22.2	32.1	25.5	25.4	26.1	26.4	25.0	24.2
Net external liabilities/CARs	81.9	68.4	71.3	92.2	69.1	66.6	63.0	62.3	60.3	59.8
Net external liabilities/CAPs	81.3	68.5	68.7	88.7	66.8	62.5	60.7	60.0	58.4	58.4
Short-term external debt by remaining maturity/CARs	20.2	20.2	20.6	24.0	20.6	19.9	21.1	20.2	18.2	18.2
Usable reserves/CAPs (months)	1.7	1.2	1.3	1.4	1.1	1.1	1.0	1.0	0.9	0.9
Usable reserves (mil. $)	1,009	1,153	1,137	1,153	1,267	1,297	1,387	1,392	1,519	1,725
Fiscal indicators (general government; %)										
Balance/GDP	(2.8)	(1.1)	(2.1)	(8.2)	(5.4)	(4.5)	(4.4)	(3.6)	(3)	(2.8)
Change in net debt/GDP	3.2	1.6	3.5	7.5	5.4	4.9	5.5	3.7	3.2	3.0
Primary balance/GDP	(1.5)	0.1	(1.0)	(7.0)	(4.2)	(3.3)	(3.0)	(2.0)	(1.4)	(1.2)
Revenue/GDP	31.0	30.4	31.4	29.9	32.4	32.4	30.5	30.5	30.5	30.5
Expenditures/GDP	33.8	31.5	33.5	38.1	37.8	36.9	34.9	34.1	33.5	33.3
Interest/revenues	4.4	3.9	3.7	4.0	3.9	3.6	4.7	5.3	5.4	5.3
Debt/GDP	44.4	45.8	46.5	57.0	58.5	57.0	57.2	57.7	57.6	57.4
Debt/revenues	143.3	150.8	148.3	190.5	180.4	176.0	187.5	189.3	189.0	188.1
Net debt/GDP	40.4	39.3	41.0	49.9	51.8	51.8	52.4	53.2	53.4	53.3
Liquid assets/GDP	4.0	6.5	5.5	7.1	6.7	5.3	4.8	4.5	4.3	4.0
Monetary indicators (%)										
CPI growth	1.4	1.5	0.8	1.2	3.2	14.4	9.0	4.0	2.6	2.6
GDP deflator growth	2.8	3.9	0.9	1.4	3.6	8.0	8.0	3.0	2.8	2.8
Exchange rate, year-end (LC/$)	51.27	53.69	54.95	50.24	54.37	57.65	57.00	54.55	52.83	52.50
Banks' claims on resident non-gov't sector growth	5.4	7.3	6.4	4.8	8.3	9.3	5.0	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	48.8	48.9	49.7	53.9	54.2	53.7	51.1	50.7	50.2	49.7
Foreign currency share of claims by banks on residents	41.7	40.3	41.2	41.2	40.3	42.2	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	40.9	40.0	38.4	39.7	42.8	44.4	N/A	N/A	N/A	N/A

Table 1

North Macedonia Selected Indicators (cont.)

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Real effective exchange rate growth	(0.4)	1.4	(1.7)	1.8	1.1	2.4	N/A	N/A	N/A	N/A

Sources: National Bank of the Republic of North Macedonia, IMF, Eurostat, State Statistical Office of Republic of North Macedonia (economic indicators); National Bank of the Republic of North Macedonia, IMF (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: We adjust usable reserves by subtracting the monetary base and required bank reserves on resident foreign-currency deposits from the reported international reserves. Government debt is adjusted by including the debt of the 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	4	Based on narrow net external debt and gross external financing needs/(current account receipts (CAR) plus usable reserves) as per Selected Indicators in table 1.
		There is a risk of marked deterioration in cost of financing given elevated rates and sizeable upcoming Eurobond redemptions in the next few years.
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.
		75% of 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 and has some ability to act as a lender of last resort for the financial system. Annual consumer price index is generally 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

Key rating factors	Score	Explanation
Notches of supplemental adjustments and flexibility	0	None.
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 Ratings List, July 10, 2023
- Sovereign Ratings History, July 10, 2023
- Sovereign Risk Indicators, July 10, 2023. A free interactive version is available at http://www.spratings.com/sri
- Sovereign Ratings Score Snapshot, July 7, 2023
- Global Sovereign Rating Trends Midyear 2023: Fragile Stability, July 5, 2023
- 2022 Annual Global Sovereign Default And Rating Transition Study, April 28, 2023

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-