

Republic of Macedonia

September 2018

Radostina Stamenova, Lead Economic Analyst
stamenova@bcra-bg.com

Kalina Dimitrova, Economic Analyst
k.dimitrova@bcra-bg.com

SOVEREIGN RATING	Initial rating	Monitoring	Review	Review
Date of Rating Committee	14.09.2015	14.04.2016	08.03.2018	04.09.2018
Date of rating publication	18.09.2015	15.04.2016	09.03.2018	07.09.2018
Long-term rating:	BB- (ns)	BB- (ns)	BB- (ns)	BB- (ns)
Outlook:	Stable	Negative	Stable	Stable
Short-term rating:	B (ns)	B (ns)	B (ns)	B (ns)

- (ns) – not solicited rating

BCRA – CREDIT RATING AGENCY AD (BCRA) is the third fully recognized rating agency in the EU, registered pursuant to Regulation No. 1060/2009 of the European Parliament and of the Council. The credit ratings, assigned by the BCRA are valid throughout the EU and are fully equal to those, of the other agencies, recognized by the European Securities and Markets Authorities, without any territorial or other limitations.

“BCRA - CREDIT RATING AGENCY” AD rates Republic of Macedonia with unsolicited sovereign long-term rating **BB- (ns)** and short-term **B (ns)** with stable outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied (http://www.bcra-bg.com/files/file_330.pdf).

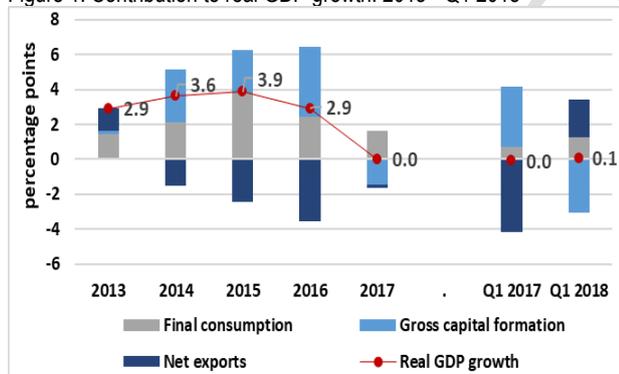
The report has been prepared and the rating – assigned, based on public information, made available by the National Bank of the Republic of Macedonia, the State Statistical Office, the Ministry of Finance, the World Bank, the International Monetary Fund, the European Commission, BCRA's database etc. BCRA uses sources of information, which it considers reliable, however it cannot guarantee the accuracy, adequacy and completeness of the information used.

Overview:

After the prolonged crisis, the **political situation** is improving. The country marks a notable progress on the **name dispute** with Greece. On June 17, 2018, Greek prime minister and his Macedonian counterpart reached an agreement the official name of the country to become "Republic of North Macedonia". The change requires constitutional amendment, thus a referendum with the question: "Are you for accession to the EU and NATO by supporting the Agreement between Greece and Macedonia?" is going to be held on September 30, 2018. Solving the name dispute is one of the preconditions for Macedonia to start accession talks with NATO once the country was invited in July. The Council of the EU also responded by stating that Macedonia will be able to open accession talks in June 2019.

The referendum outcome is considered a key for the continuation of the pro-western reform policy of the SDSM-led government coalition as well as for its own stability in domestic perspective.

Figure 1: Contribution to real GDP growth: 2013 - Q1 2018



Source: State Statistical Office

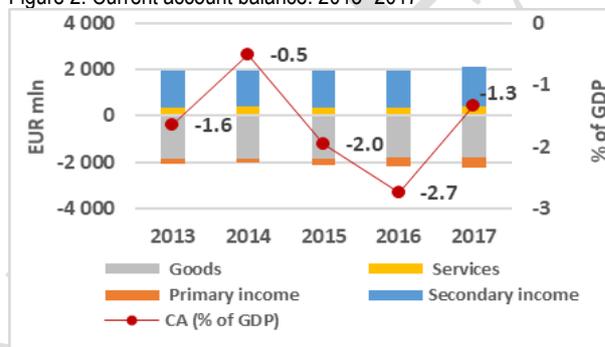
The political crisis has negatively impacted the **GDP growth**. Following a slowdown to 2.9% in 2016, economic activity stagnated in 2017. A modest growth of 0.1% is registered in the first quarter of 2018, however, GDP growth is expected to accelerate amid regained investors' confidence and continued political stability.

Private consumption and net exports have positive contributions to the economic growth. In the first quarter of the year, household final consumption (including NPISHs) increases by 2.3% in real terms, while public consumption drops by 1.4%. Gross investments decrease by 9.0% due to the decline

experienced in the construction works. Exports growth accelerates to 10.6%, while imports growth markedly decelerates to 5.1%.

The services, industrial and agricultural sectors perform well, thus, supporting the economic growth. On the other hand, construction sector constrains the outcome in the first quarter of 2018, as the construction activity drops by 37.2% in relation to the same prior year period.

Figure 2: Current account balance: 2013 -2017



Source: National Bank of Macedonia

Macedonia's **current account** deficit narrows from 2.7% of GDP in 2016 to 1.3% in 2017. At the end of the first quarter of 2018, current account records a deficit in the amount of EUR 158 million or 1.5% of the projected GDP in 2018. The negative balance increases by 8.5% on annual basis, due to higher deficit on the primary income account, increased trade deficit and lower surplus of the services account by 3.1%, while the positive balance on the secondary income expands.

The current account deficit is fully financed with **foreign direct investment (FDI)** inflows. Net FDIs in the first quarter of 2018 amount to EUR 233 million, increasing by EUR 122 million (109.4%) on an annual basis.

At the end of March 2018, **gross external debt** stands at EUR 8 298 million or 78.7% of the projected GDP. Compared to the end of 2017, gross external debt increases by EUR 895 million mostly due to the increased public debt (amid the new Eurobonds issue) and higher liabilities arising from repo arrangements of the Central Bank. The maturity structure remains favourable, with 72.3% of total debt being long-term debt.

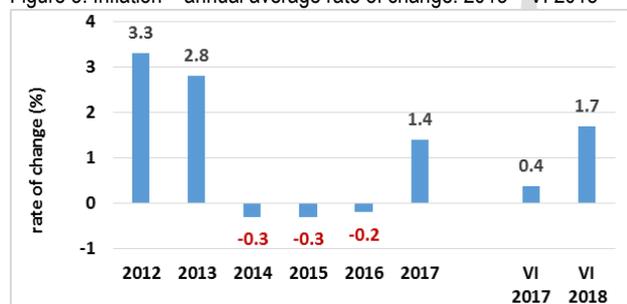
The sustained minimum volatility of the **MKD/EUR exchange rate** improves the soundness of the

economic state but makes it necessary for the country to maintain a high level of **foreign reserves**. At the end of the first quarter of 2018, reserve assets stand at EUR 2 577 million (23.9% of the projected GDP), ensuring more than 4 months coverage of imports.

Labour market dynamics are characterized by rise of employment and reduction of unemployment. In the first quarter of 2018, employment rate reaches 44.6%, while the pool of unemployed decreases to 21.6% of the active population (from 22.9% a year earlier). The unemployment rate, however, remains at alarmingly high levels, much higher than representative EU-members, whilst the economic activity - respectively lower (56.9% in Q1 2018). This implies that regardless the decade (2006-2017) of purposeful policy against the high unemployment, some serious structural problems in the economy still persist.

Average **net wage** in the economy keeps its upward movement, increasing nominally by 4.9% on an annual basis with still the highest growth rate in the sector of *Mining and quarrying*.

Figure 3: Inflation – annual average rate of change: 2013 – VI 2018

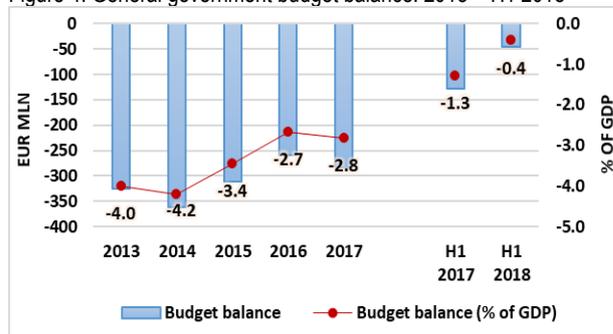


Source: State Statistical Office

Annual average **inflation rate**, measured by CPI, reaches 1.7% as of mid-2018. The growth of consumer prices since the beginning of the year has been mainly driven by higher food and transport prices, contributing by 0.5 and 0.6 p.p., respectively to the value of the index.

General government **budget deficit** in 2017 stands at EUR 284 million or 2.8% of GDP. The Macedonian government plans to cut the budget deficit to 2.7% of GDP in 2018. Also the recently adopted Fiscal strategy for the period 2019-2020 envisages a gradual fiscal consolidation and a reduction of the budget deficit to 2% of GDP in 2021.

Figure 4: General government budget balance: 2013 – H1 2018



Source: Ministry of Finance

In the first half of 2018, consolidated budget revenues nominally increase by 5.1% on annual basis driven by higher taxes and social contributions. Simultaneously, consolidated budget expenditures mark 0.4% nominal decrease, mainly due to lower capital expenditures (-48.2%). Thus, the budget deficit amounts to EUR 45 mln, which is by EUR 83 million lower than deficit recorded in the first half of 2017.

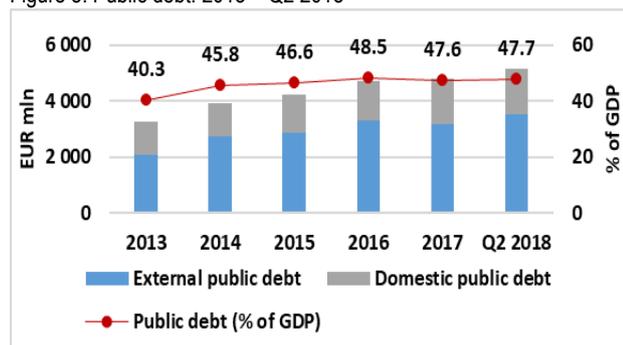
Although it has been gradually growing since 2009, **general government gross debt** of Macedonia is still below the limit of 60% of GDP. The ratio may be considered as a positive factor, as opposed to the continuous increase in the public debt. Its growth may be a notice of a potential risk related to the government's growing dependence on debt issuance as a method of financing its expenditures rather than provide for them with collected revenues.

At the end of June 2018, **general government debt** stands at EUR 4 300 million (39.9% of the projected GDP), increasing by 8.6% against the end of 2017. In January 2018, Macedonia successfully issued a EUR 500 million **Eurobond** on the international capital market, with a maturity period of seven years. The interest rate of 2.75% is the lowest achieved for any of Macedonia's Eurobond issues. As regards the domestic debt, in April 2018, Macedonia issued its first 30-year domestic government bond in an amount of EUR 20 million and with 4.85% coupon.

The refinancing risk decreases, as the maturity structure improves. At the end of June 2018, long-term government securities account for 59.8% in the maturity structure (compared to 34.6% at the end of 2013). In terms of currency, round 80% of the general government debt is denominated in

foreign currency, mainly in euros. The large amount of debt denominated in foreign currency could affect the repayment costs, however, the risk of devaluation is low, as the denar is informally pegged to the euro.

Figure 5: Public debt: 2013 – Q2 2018



Source: Ministry of Finance

At the end of June 2018, **public debt**¹ stands at EUR 5 139 million, accounting for 47.7% of the projected GDP. External public debt amounts to EUR 3 515 million and prevails in structure with a share of 68.4%, while domestic public debt amounts to EUR 1 624 million or 31.6% of total public debt.

Overall uncertainty in the country which affected the performance of the **banking sector** in 2016 and the beginning of 2017 seems overcome, as the growth rates of main banking aggregates accelerate in the first quarter of 2018. Deposits as well as gross loans to the non-financial sector have been growing at higher rates since the beginning of 2018 (compared to the same period of 2017) mainly through the denar-denominated segments meaning a restoring confidence in the domestic currency. The banking system is well capitalised, as the total capital adequacy ratio reaches 16.4%.

In conditions of further stabilisation and increased confidence of the economic agents, in August 2018, NBRM decided to reduce the **reference interest rate** by 0.25 p.p. to a historically low level of 2.75%.

Outlook:

The **stable** outlook of the Sovereign Rating of the Republic of Macedonia reflects the BCRA's opinion that the upside and downside risks to the rating are currently balanced and do not affect the creditworthiness of the country.

Factors that could lead to a **positive** pressure on the Sovereign Rating and/or the Outlook include:

- Further reduction in political risk through political stability and faster progress on structural reforms towards EU accession;
- Implementation of a credible medium-term fiscal consolidation programme and reduction of the public debt burden;
- Higher and broad-based economic growth;
- Increased resilience to external shocks.

Negative pressures on the Sovereign Rating and/or the Outlook may arise in case of:

- Renewing of political instability;
- Fiscal metrics deterioration;
- Intensification in external imbalances and capital outflows related to sudden shift in investors' sentiment.

¹ Pursuant to the Law on Public Debt, public debt is broader definition of the debt, including the general government debt and the guaranteed debt of public enterprises and companies fully or dominantly owned by the state or the debt of municipalities.

Regulatory announcements

Rating initiative

This is an unsolicited sovereign rating. Neither the rated entity, nor a related third party has participated in the credit rating process. BCRA did not have access to the accounts, management and other relevant internal documents for the rated entity or a related third party.

Please, visit www.bcra-bg.com to review BCRA's full policy on unsolicited credit/sovereign ratings.

Clarifying Notes:

There may be some differences in the stated values and changes in the analysed indicators due to the conversion of those values in another currency (namely in EUR). The used exchange rate is the publically announced by the National Bank of Republic of Macedonia as the average value for the corresponding period (i.e. yearly, quarterly and monthly). There may also be some differences stemming from using average values for the period rather than end-period values. The cited growth rates in the current report are based on changes in national currency, with the exception of data recorded in EUR (i.e. Balance of payments, External debt, Net international investment position). The data on which the current report is based includes the public data available until the end of August 2018.

Summary of the minutes of the Rating Committee:

On the 4th of September 2018 Rating Committee of BCRA – CREDIT RATING AGENCY (BCRA) had a session, on which the **Report regarding the review of an unsolicited sovereign rating of Republic of Macedonia** was discussed.

The members of the Rating Committee discussed the grades of numerous credit rating factors included in the **Model for grading** and analysed in the **Credit Rating Report** in accordance with the **Sovereign Rating Methodology**.

The dynamics of the political processes after the conclusion of the strategic partnership agreement with Greece was discussed. The efforts for enhanced cooperation of the country with key international organizations were positively assessed.

The two-year political instability affected economic activity in the country and as of mid-2018, negative trends have not been overcome, yet. The economic growth remains negligible in the first quarter of 2018 with an accelerated growth in household consumption and export compared to a year earlier.

The balance of payments current account is improving.

The government budget deficit narrows whereas the execution of the capital expenditures remains low. Public debt continues to grow nominally.

It was commented that banking system indicators demonstrate favourable levels, as well as that the lending activity of the non-financial sector indicates for recovery.

The sovereign rating and the related outlook have been determined based on the above discussion.

Tables:

Country	Development classification
Republic of Macedonia	Emerging and Developing Europe (IMF classification)

MAIN MACROECONOMIC INDICATORS							
	2018 Q1	2017 Q1	2017	2016	2015	2014	2013
Gross domestic product (real growth rate)	0.1	0.0	0.0	2.9	3.9	3.6	2.9
Gross domestic product (EUR mln) ¹	2 428	2 322	10 066	9 723	9 072	8 562	8 150
Final consumption	1 957	1 894	8 264	7 987	7 786	7 442	7 274
Gross capital formation	846	787	3 184	3 169	2 758	2 594	2 348
Exports	1 389	1 258	5 547	4 859	4 422	4 081	3 537
Imports	1 764	1 617	6 930	6 292	5 894	5 555	5 009
Unemployment rate ² (%)	21.6	22.9	22.4	23.7	26.1	28.0	29.0
Average net monthly wage (EUR) ¹	384	366	372	363	356	347	343
GDP per capita (EUR)	-	-	4 853	4 691	4 382	4 141	3 948
	2018 I-VI	2017 I-VI	2017	2016	2015	2014	2013
CPI - annual average rate of change (last 12 months)	1.7	0.4	1.4	-0.2	-0.3	-0.3	2.8
CPI - annual rate of change (end of period)	1.4	1.5	2.4	-0.2	-0.3	-0.5	1.3
MKD/EUR - period average	61.53	61.60	61.57	61.60	61.61	61.62	61.58
MKD/USD - period average	50.82	56.98	54.67	55.69	55.50	46.44	46.40
EXTERNAL SECTOR							
	2018 Q1	2017 Q1	2017	2016	2015	2014	2013
<i>EUR millions</i>							
Current account	-158	-145	-134	-265	-177	-43	-134
Goods	-474	-464	-1 800	-1 809	-1 823	-1 856	-1 863
Services	97	100	400	347	349	384	375
Primary income	-110	-105	-424	-384	-286	-161	-193
Secondary income	329	324	1 691	1 581	1 583	1 589	1 547
Foreign direct investments, net	233	111	229	317	203	197	229
Gross external debt	8 298	7 716	7 403	7 217	6 291	5 992	5 220
NIIP	-6 324	-5 779	-6 022	-5 576	-5 083	-4 549	-4 558
Official reserve assets	2 577	2 534	2 336	2 613	2 262	2 436	1 993
<i>% of GDP³</i>							
Current account	-1.5	-1.4	-1.3	-2.7	-2.0	-0.5	-1.6
Goods	-4.4	-4.6	-17.9	-18.6	-20.1	-21.7	-22.9
Services	0.9	1.0	4.0	3.6	3.8	4.5	4.6
Primary income	-1.0	-1.0	-4.2	-3.9	-3.2	-1.9	-2.4
Secondary income	3.1	3.2	16.8	16.3	17.4	18.6	19.0
Foreign direct investments, net	-2.2	-1.1	-2.3	-3.3	-2.2	-2.3	-2.8
Gross external debt	79	77	74	74	69	70	64
NIIP	-58.7	-57.4	-59.8	-57.3	-56.0	-53.1	-55.9
Official reserve assets	23.9	25.2	23.2	26.9	24.9	28.5	24.5

PUBLIC FINANCE							
	2018	2017	2017	2016	2015	2014	2013
EUR millions ¹	Q2	Q2					
General government revenues	1 577	1 499	3 108	2 951	2 809	2 543	2 450
General government expenditures	1 622	1 627	3 392	3 209	3 120	2 904	2 775
General government budget balance	-45	-128	-284	-258	-312	-361	-325
General government gross debt	4 300	3 885	3 958	3 852	3 453	3 262	2 772
Public debt	5 139	4 708	4 787	4 711	4 227	3 921	3 281
External public debt	3 515	3 255	3 188	3 286	2 848	2 725	2 079
Domestic public debt	1 624	1 454	1 599	1 425	1 380	1 196	1 203
% of GDP ³							
General government revenues	14.6	14.9	30.9	30.3	31.0	29.7	30.1
General government expenditures	15.0	16.2	33.7	33.0	34.4	33.9	34.1
General government budget balance	-0.4	-1.3	-2.8	-2.7	-3.4	-4.2	-4.0
General government gross debt	39.3	38.6	39.6	39.6	38.1	38.1	34.0
Public debt	47.6	46.8	48.5	48.5	46.6	45.8	40.3
External public debt	31.7	32.3	33.8	33.8	31.4	31.8	25.5
Domestic public debt	15.9	14.4	14.7	14.7	15.2	14.0	14.8
BANKING SYSTEM							
	2018	2017	2017	2016	2015	2014	2013
ratios (%)	Q1	Q1					
Capital adequacy ratio	16.4	15.4	15.7	15.2	15.5	15.7	16.8
Liquid assets / Total assets	27.4	27.8	27.1	28.9	28.2	29.8	31.2
Highly liquid assets / Total assets	22.8	24.2	23.2	25.7	24.3	25.5	27.3
Non-performing loans/ Total loans (NF sector)	5.1	6.4	6.3	6.6	10.8	11.3	11.5
Return on assets (ROA)	3.1	1.5	1.4	1.5	1.1	0.8	0.6
Return on equity (ROE)	28.0	13.8	13.5	13.6	10.4	7.4	5.7
Total assets / GDP	74.4	72.6	74.5	74.3	75.8	75.9	73.6
EUR millions ⁴							
Total (gross) loans (to non-financial entities)	4 798	4 514	4 839	4 570	4 506	4 115	3 741
Total deposits (of non-financial entities)	5 505	5 152	5 518	5 250	4 971	4 668	4 215
Total assets	7 577	7 090	7 513	7 233	6 878	6 511	6 007
Financial result (net profit/ loss)	58	27	107	103	75	51	38

[1] The values in EUR are calculated by using the average exchange rate of the MKD/EUR for the corresponding period.

[2] Population aged 15 years and over.

[3] 2018 data are calculated on the basis of GDP amounting to MKD 663 250 million (Ministry of Finance projection).

[4] The values in EUR are calculated by using the exchange rate of the MKD/EUR at the corresponding period's end.

Sources: National Bank of Republic of Macedonia, State Statistical Office, Ministry of Finance, World Bank, Eurostat, International Monetary Fund