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Republic of North Macedonia

August 2019

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SOVEREIGN RATING	Initial rating	Monitoring	Review	Review	Review
Date of Rating Committee	14.09.2015	14.04.2016	08.03.2018	28.02.2019	29.08.2019
Date of rating publication	18.09.2015	15.04.2016	09.03.2018	01.03.2019	30.08.2019
Long-term rating:	BB- (ns)	BB- (ns)	BB- (ns)	BB- (ns)	BB- (ns)
Outlook:	Stable	Negative	Stable	Positive	Positive
Short-term rating:	B (ns)	B (ns)	B (ns)	B (ns)	B (ns)

- (ns) – not solicited rating

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"BCRA - CREDIT RATING AGENCY" AD rates Republic of North Macedonia with unsolicited sovereign long-term rating BB- (ns) and short-term B (ns) with positive outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied (https://www.bcra-bg.com/files/Sovereign_Methodology_2014_en.pdf).

The report has been prepared and the rating – assigned, based on public information, made available by the National Bank of the Republic of North 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.

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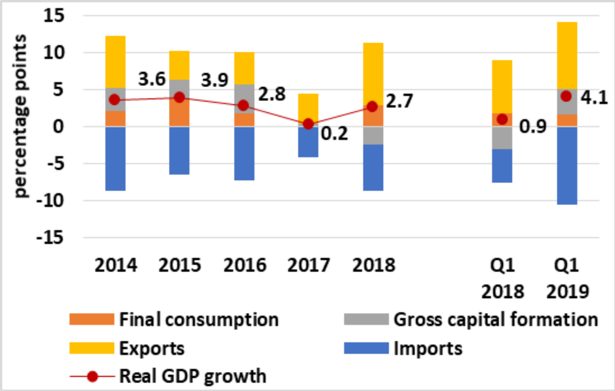
Overview:

Macedonian authorities remain engaged in the process of **Euro-Atlantic integration** of the country. On February 12, 2019, the Prespa Agreement[1] entered into force, under which the country is officially renamed as Republic of North Macedonia, thus, paving their way towards a broader international cooperation. Subsequently, Greece unblocked the Macedonian bid for NATO membership and became the first among the members of the alliance to ratify the accession protocol. In May 2019, the European Commission recommended opening accession negotiations[2], and the enlargement commissioner Johannes Hahn praised the Prespa Agreement, the successful organisation of the 2018 presidential elections and the progress in the judiciary. EC noted in its country report that progress has been identified also in other problematic issues like public administration and national legislation in entirety.

Figure 1: Contribution to real GDP growth: 2014 – Q1 2019

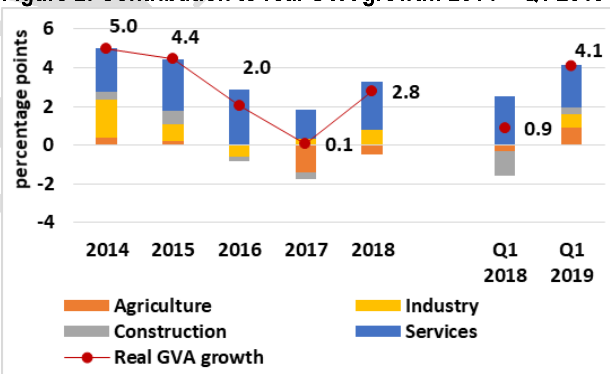


Source: State Statistical Office

Following the stagnation in 2017, economic activity rebounded in 2018 with **GDP growth** reaching 2.7% in real terms. Consumption and net exports were the growth drivers on the expenditure side, while gross investments remained subdued - annually decreasing by 7.2% in 2018. The economic activity is expected to pick up gradually in the following years, as both private and public investments are projected to strengthen due to improved political stability and more realistic prospects for EU accession.

In the first quarter of 2019, annual GDP growth markedly accelerated to 4.1% from 0.9% in the corresponding period of 2018, being driven by both consumption and investment. Supported by the favourable labour market developments, private consumption picked up by 2.6% on an annual basis, while the growth of public consumption decelerated to 0.1%. Following the sharp decline in 2018, gross capital formation expanded by 9.8% during the first quarter of 2019, mainly as a result of higher investment in construction works, as well as more dynamic crediting to the corporate sector. Although the real growth of exports accelerated to 15.6%, from 12.8% in Q1 2018, net exports had a negative contribution to the GDP growth, as the acceleration in imports growth was much more pronounced – from 6.2% in Q1 2018 to 14.4% in Q1 2019.

Figure 2: Contribution to real GVA growth: 2014 – Q1 2019



Source: State Statistical Office

On the supply side, **gross value added** annually increased by 4.1% in the first quarter of 2019, backed by positive developments in almost all activities. The aggregate services sector expanded by 2.7% in real terms, mainly as a result of 6.6% higher activity in trade, transportation, food and accommodation services, whereas drop of activity was registered at financial and insurance services (-1.1%) and information and communication services (-0.7%). Value added in the agriculture sector picked up by 13.6% on an annual basis, thus having a large positive contribution to the overall GVA growth in Q1 2019. Activity in the industrial sector remained robust, increasing by 3.4% in relation to the same prior-year period. Favourable

[1] The Agreement from Prespa (June 2018) solved the long-lasting name dispute between Skopje and Athens. Defining of a mutually recognized name for the former Yugoslav republic was one of the preconditions for Macedonia to start accession talks with NATO and EU.

[2] The country has been a candidate for accession to the EU since 2005.

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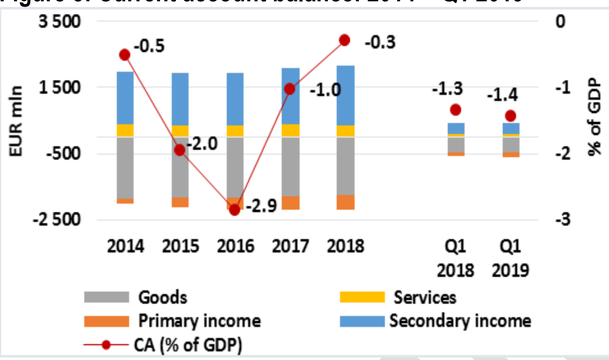
trends were observed also in the construction activity which surged by 7.0% in real terms.

North Macedonia **trades** most actively with the EU member states, which accounted for 82.2% of total exports and 63.4% of total imports of goods in the first half of 2019, compared to 83.3% and 63.8% a year earlier, respectively. Germany is the most important trade partner, accounting for almost half of the exports and more than 1/10 of country's imports. Top export destinations included also Bulgaria, Kosovo, Serbia and Greece, while the United Kingdom, Italy and China were among the top import origins. In the period January – June 2019, nominal exports of goods increased by 14.1% on annual basis, while the imports grew at a slower rate of 11.2%.

Figure 3: Current account balance: 2014 – Q1 2019



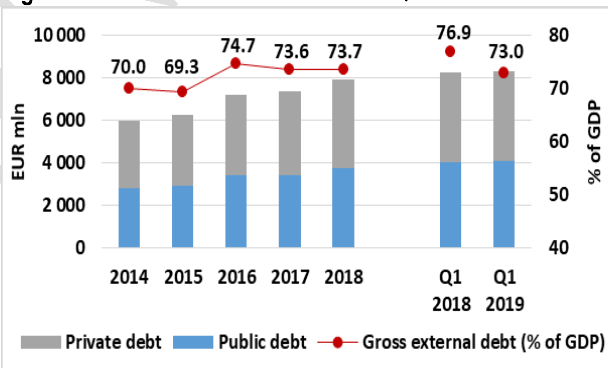
Source: NBRNM

External vulnerabilities remain contained. The **current account** deficit narrowed from EUR 103 million (1% of GDP) in 2017 to EUR 32 million (0.3% of GDP) in 2018, driven by a further reduction in the trade deficit as well as by higher transfers from abroad. However, the current account deficit slightly widened in the first quarter of 2019 as the investment-related imports strongly accelerated, driving a trade balance deterioration. In the period January-March 2019, the current account posted a deficit of EUR 162 million (1.4% of the projected GDP), as opposed to the deficit of EUR 144 million (1.3 % of GDP) in the same prior-year period.

The current account deficit has been fully financed by long-term capital inflows in the form of **foreign direct investment**. After a slump in 2017, FDI inflows in the country picked up markedly in 2018, reaching EUR 624 million or 5.8% of GDP - the highest level recorded since 2008. Foreign investments were mainly allocated in the industry sector, in particular in the manufacturing, which provides a future potential for the country's exports. FDIs in the first quarter of 2019 amounted to EUR 30 million, annually decreasing by EUR 205 million. The reduction was a result of an outflow of EUR 143 million on the basis of debt instruments, while investment in the form of equity and reinvestment picked up to EUR 173 million.

Enabling steady FDI inflows is crucial for country's medium-term growth prospects. Given the already attractive tax regime and financial incentives to foreign firms, strengthening of institutions would be key to attracting foreign investors. North Macedonia ranked 10th out of 190 economies in the World Bank's **Doing Business Report** for 2019, being the top performer in Southeast Europe. However, insufficient administrative service and allegations of widespread corruption continue to hamper the business climate in the country. This is confirmed by the 2018 Corruption Perceptions Index by Transparency international which put Macedonia at 93rd place out of 180 economies.

Figure 4: Gross external debt: 2014 – Q1 2019



Source: NBRNM

Gross external debt remained elevated, amounting to EUR 8 304 million or 73% of the projected GDP as of Q1 2019. Compared to the end of 2018, gross external debt increased by EUR 397 million, mainly as a result of NBRNM repo transactions. Excluding their effect, gross external debt stood at EUR 8 006 million. Despite the increase in the relative share of short-term debt (by 2.7 pp.), the maturity structure remains broadly favourable, with 71.5% of the total debt being long-term.

Country's negative **net international investment position** amounted to EUR 6 122 million (53.8% of the projected GDP) at the end of March 2019,

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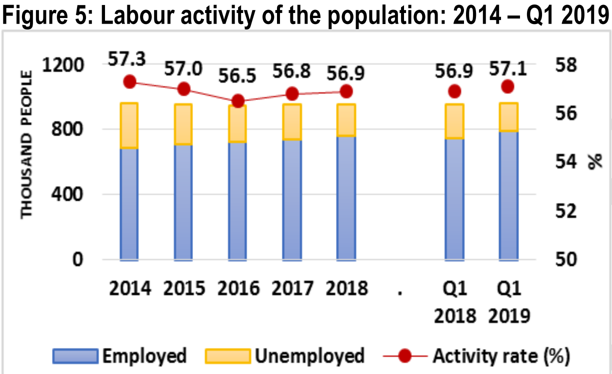
compared to EUR 5 946 million (55.4% of GDP) at the end of 2018. The sizable negative NIIP poses some risks to external sustainability, however, they are partly mitigated by the large share of net liabilities on direct investments - representing 83.9% of NIIP.

North Macedonia has a de facto stabilized **exchange rate arrangement**. The sustained minimum volatility of the MKD/EUR exchange rate improves the soundness of country's economic state, but makes it necessary to maintain a secure level of **foreign reserves**. At the end of June 2019, official reserves amounted to EUR 2 928 million (25.7% of the projected GDP), increasing by 2.1% compared to the end of 2018. The level of reserves remains broadly adequate, providing about 4 months coverage of imports.

Figure 5: Labour activity of the population: 2014 – Q1 2019

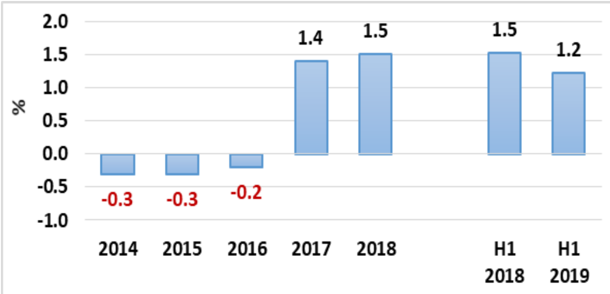


Source: State Statistical Office

Labour market gradual improvement has continued in 2018 and early 2019. In the first quarter of 2019, employment rate increased to 46.9%, and the economic activity – to 57.1% for population above 15 years. The pool of unemployed decreased to 17.8% of the active population (from 21.6% a year earlier). Despite the reduction in unemployment rate, the last remains at alarmingly high levels, especially in vulnerable population groups like youths and long-term unemployed implying that structural problems are still present at the market. What rises special concern is that the share of highly educated (university graduates) has expanded to 1/5 of total unemployed in 2017 and 2018. In this regard, more active measures to improve the business environment and the adequacy of education in the country should be considered.

In most of the economic sectors average **net wage** increased on an annual basis, as a whole by 2.2% in real terms (3.4% in Q1 2018), with the best paid employees at the sector of Information and communication getting EUR 709 compared to EUR 397 on average for the economy.

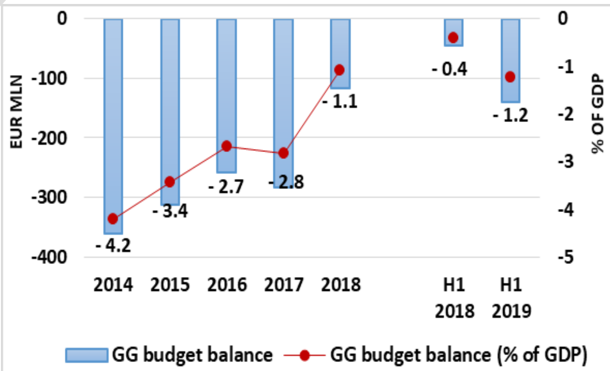
Figure 6: CPI – annual average rate of change: 2014 – H1 2019



Source: State Statistical Office

Following the only slight acceleration in 2018, annual consumer price **inflation** has eased to 0.3% in June 2019, from 1.4% in June 2019. The average inflation rate in the first half of 2019 amounted to 1.2% (1.5% in the same period of 2018), being mainly a result of higher food prices as well as higher prices of alcoholic beverages and tobacco, while the contribution of energy prices was negative.

Figure 7: General government budget balance: 2014 – H1 2019



Source: Ministry of Finance

General government budget deficit narrowed from 2.8% of GDP in 2017 to 1.1% of GDP in 2018, being significantly lower than the initially planned, mostly due to the large under-execution of capital spending. The structure of expenditure deteriorated further as the share of capital expenditure drooped to only 8% in 2018 (from 14.5% in 2012). The aggregate revenues also underperformed, although collections of social security contributions and

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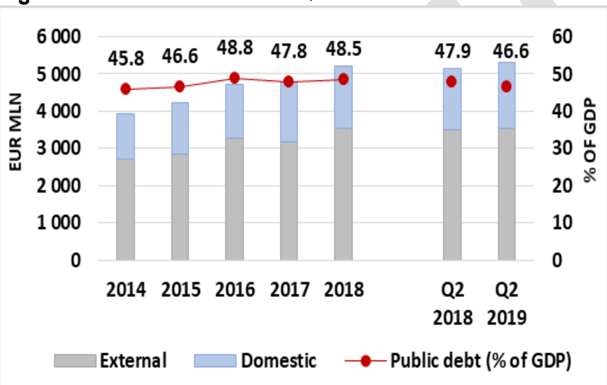
corporate income tax exceeded the budget plan for 2018. Interest-related expenditures declined by 8.4% on annual basis, accounting for 1.2% of GDP in 2018.

The overall fiscal deficit is projected to pick up to 3% of GDP in 2019, mainly reflecting the planned intensification of public infrastructure projects. In the first half of 2019, general government revenues annually increased by 5.3%, whereas collections from taxes and contributions rose by 2.4% and non-tax revenues grew by 54.3%. At the same time, total expenditures expanded by 11% on account of 9.4% higher current expenditures and 36.5% higher capital spending. As a result, the consolidated budget deficit reached EUR 139 million, compared to EUR 45 million in the first half of 2018.

A gradual fiscal consolidation is projected in medium-term, as the general government budget deficit is expected to decrease from 3% of GDP in 2019 to 2.3% of GDP in 2020 and further to 2% of GDP in 2021 and 2022. However, a more ambitious consolidation programme should be considered, in order to faster reduce the public debt burden and rebuild the fiscal space while supporting the economic activity.

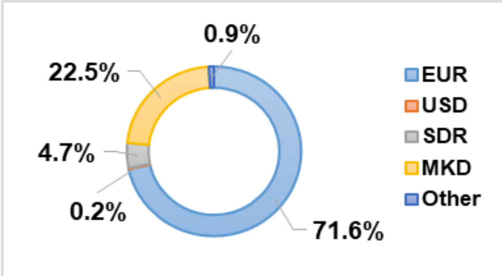
Figure 8: Public debt: 2014 - Q2 2019



Source: Ministry of Finance

Public debt[3] of the Republic of North Macedonia stood at EUR 5 300 million (46.6% of the projected GDP) at the end of June 2019, increasing by EUR 98 million compared to the end of 2018. The relative share of external debt dropped by 0.9 pp. to 67.1% of total public debt, while the share of domestic debt picked up to 32.9%, respectively.

Figure 9: Currency structure of GG debt: June 2019



Source: Ministry of Finance

Debt structure has been improving in recent years as the relative share of debt with fixed interest rate reached 77.4% of total general government debt at the end of June 2019, compared to 76.9% at the end of 2018. Concurrently, the repayment costs may be negatively affected by the foreign-currency denominated debt which accounted for 77.5% of total debt. However, the exchange rate risk is low given the fact that the denar is informally pegged to the euro.

The increased issuance of long-term government securities in recent years reduces the refinancing risk, but the maturity structure needs further improvements as the share of short-term securities (33.1% of total amount outstanding at the end of June 2019) is still elevated. Debt roll-over needs would peak in the next two years, when two Eurobonds issues (in the total amount of EUR 678 million[4]), as well as the second instalment of the loan secured from the World Bank (EUR 155 million), fall due for repayment. Afterwards, the refinancing risk is expected to decline as a result of the extended maturity of the external debt portfolio.

According to the Fiscal Strategy for the period 2020-2022, a moderate increase of the total public debt is expected in the medium-term - to 52.3% of GDP in 2020, followed by a decline in 2021 and 2022 to 49.1% of GDP.

Over 2018, the **banking system** performed well as recorded fast acceleration of main banking aggregates after the slowdown from the 2016-2017 period of institutional uncertainty. These trends

[3] Public debt is broader definition of the debt, including the general government debt and the guaranteed and non-guaranteed debt of public enterprises and companies fully or dominantly owned by the state or municipalities.

[4] In January 2018, Ministry of Finance made an early repayment in the amount of EUR 91.7million of part of the Eurobond falling due in 2020.

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were continued in Q1 2019. With the increase of credit activity, the ratio of non-performing loans lowered to 5.2% as of Q1 2019 (5.1% for Q1 2018). In 2018, an improvement of the financial result (even the small-sized banks), backed by notably decreased impairments costs was observed. The total capital adequacy ratio of the system increased to 17.0% as of Q1 2019 as for the continuous increase of the own funds that exceeded those of the risk-weighted assets.

Considering indications for absent pressures in the external sector and stable perceptions of the domestic entities, the NBRNM further eased its monetary policy stance after the **key policy rate** was cut by 0.25 pp. three times in 2018 to the level of 2.50%. The rate on CB bills was additionally lowered in March 2019 to reach 2.25%, while at the same time the central bank stood sound in complying its price stability target.

Outlook:

The **positive** outlook of the Sovereign Rating of the Republic of North Macedonia reflects the stabilization of the political environment which has resulted in a pickup in economic activity and material progress towards Euro-Atlantic integration. However, the sovereign rating remains constrained by low GDP per capita, institutional weaknesses, high unemployment and large informal economy.

Positive pressures on the Sovereign Rating and/or the Outlook would be considered:

- Opening of the EU accession negotiations;
- Progress in the rule of law and the fight against corruption;
- Implementation of a more ambitious fiscal consolidation programme, reducing the public debt burden;
- Increased resilience to external shocks.

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

- Renewed political uncertainty;
- Fiscal metrics deterioration;
- Sudden capital outflows related to sudden shift in investors' sentiments;
- Pressures on foreign exchange reserves amid widening of external imbalances.

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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.

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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 North 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 middle of August 2019.

Summary of the minutes of the Rating Committee:

On the 29th of August 2019 Rating Committee of BCRA – CREDIT RATING AGECY (BCRA) had a session, on which the **Report regarding the affirmation of an unsolicited sovereign rating of Republic of North 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 continuing recovery of economic and (non-financial sector) credit activity in the economy was positively evaluated as well as the long-standing peg of denar to the euro, backed by adequate foreign reserves. Government budget execution and the structure of government debt were discussed. Other key points discussed by the Rating Committee were Country's path towards NATO and EU membership, as well as the levels of key external sector indicators.

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

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Tables:

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

MAIN MACROECONOMIC INDICATORS							
	2019 Q1	2018 Q1	2018	2017	2016	2015	2014
Gross domestic product (real growth rate)	4.1	0.9	2.7	0.2	2.8	3.9	3.6
Gross domestic product (EUR million)	2 542	2 394	10 735	10 014	9 657	9 072	8 562
Final consumption	2 023	1 949	8 541	8 091	7 952	7 786	7 442
Gross capital formation	893	806	3 541	3 303	3 139	2 758	2 594
Exports of goods and services	1 618	1 407	6 477	5 548	4 892	4 422	4 081
Imports of goods and services	1 992	1 767	7 825	6 927	6 327	5 894	5 555
Unemployment rate[1] (%)	17.8	21.6	20.7	22.4	23.7	26.1	28.0
Average net monthly wage (EUR)	397	384	395	372	363	356	347
GDP per capita (EUR)	-	-	5 190	4 936	4 691	4 382	4 141
CPI - annual average rate of change (%)	1.2	1.5	1.5	1.4	-0.2	-0.3	-0.3
MKD/EUR - period average	61.53	61.56	61.51	61.57	61.60	61.61	61.62
MKD/USD - period average	54.17	50.09	52.10	54.65	55.69	55.50	46.44

EXTERNAL SECTOR							
EUR million	2019 Q1	2018 Q1	2018	2017	2016	2015	2014
Current account	-162	-144	-32	-103	-275	-177	-43
Goods	-473	-463	-1737	-1788	-1813	-1823	-1856
Services	98	103	358	377	341	349	384
Primary income	-114	-114	-450	-398	-384	-286	-161
Secondary income	326	329	1797	1706	1581	1583	1589
Foreign direct investments	30	235	624	182	338	217	205
Gross external debt	8304	8251	7908	7372	7217	6291	5992
Net international investment position	-6 122	-6 109	-5 946	-5 823	-5 576	-5 083	-4 549
Official reserve assets	2 928	2 642	2 867	2 336	2 613	2 262	2 436
% of GDP[2]							
Current account	-1.4	-1.3	-0.3	-1.0	-2.9	-2.0	-0.5
Goods	-4.2	-4.3	-16.2	-17.9	-18.8	-20.1	-21.7
Services	0.9	1.0	3.3	3.8	3.5	3.8	4.5
Primary income	-1.0	-1.1	-4.2	-4.0	-4.0	-3.2	-1.9
Secondary income	2.9	3.1	16.7	17.0	16.4	17.4	18.6
Foreign direct investments	0.3	2.2	5.8	1.8	3.5	2.4	2.4
Gross external debt	73	77	74	74	75	69	70
Net international investment position	-53.8	-56.9	-55.4	-58.1	-57.7	-56.0	-53.1
Official reserve assets	25.7	24.6	26.7	23.3	27.1	24.9	28.5

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PUBLIC FINANCE							
EUR millions	**2019 H1**	**2018 H1**	**2018**	**2017**	**2016**	**2015**	**2014**
General government revenues	1 577	1 660	3 265	3 108	2 951	2 809	2 543
General government expenditures	1 622	1 799	3 382	3 392	3 209	3 120	2 904
Interest expenditures	36	45	126	137	112	106	83
General government budget balance	-45	-139	-116	-284	-258	-312	-361
General government debt	4 375	4 300	3 958	3 958	3 852	3 453	3 262
Guaranteed debt	888	839	858	828	860	774	659
Public debt	5 300	5 139	5 202	4 787	4 711	4 227	3 921
External public debt	3 555	3 515	3 538	3 188	3 286	2 848	2 725
Domestic public debt	1 745	1 624	1 664	1 599	1 425	1 380	1 196
% of GDP[2]							
General government revenues	14.7	14.6	30.4	31.0	30.6	31.0	29.7
General government expenditures	15.1	15.8	31.5	33.9	33.2	34.4	33.9
Interest expenditures	0.3	0.4	1.2	1.4	1.2	1.2	1.0
General government budget balance	-0.4	-1.2	-1.1	-2.8	-2.7	-3.4	-4.2
General government gross debt	38.4	40.1	40.5	39.5	39.9	38.1	38.1
Guaranteed debt	7.8	7.8	8.0	8.3	8.9	8.5	7.7
Public debt	46.6	47.9	48.5	47.8	48.8	46.6	45.8
External public debt	31.2	32.7	34.0	34.0	34.0	31.4	31.8
Domestic public debt	15.3	15.1	14.8	14.8	14.8	15.2	14.0

BANKING SYSTEM							
ratios (%)	**2019 Q1**	**2018 Q1**	**2018**	**2017**	**2016**	**2015**	**2014**
Capital adequacy ratio	17.0	16.4	16.5	15.7	15.2	15.5	15.7
Liquid assets / Total assets	26.7	27.4	26.7	27.1	28.9	28.2	29.8
Highly liquid assets / Total assets	22.6	22.8	22.6	23.2	25.7	24.3	25.5
Non-performing loans/ Total loans (non-financial sector)	5.2	5.1	5.2	6.3	6.6	10.8	11.3
Return on assets (ROA)	1.5	3.1	1.7	1.4	1.5	1.1	0.8
Return on equity (ROE)	13.5	28.0	16.0	13.5	13.6	10.4	7.4
Total assets / GDP	75.9	74.6	76.2	74.9	74.8	75.8	75.9
EUR million[3]							
Total (gross) loans (to non-financial entities)	5 240	4 798	5 205	4 839	4 570	4 506	4 115
Total deposits (of non-financial entities)	6 033	5 505	6 038	5 518	5 250	4 971	4 668
Total assets	8 252	7 577	8 187	7 513	7 233	6 878	6 511
Financial result (net profit/ loss)	31	58	136	107	103	75	51

[1] Population aged 15 years and over, LFS.
[2] 2019 data are calculated on the basis of GDP amounting to EUR 11 379 million (Ministry of Finance projection).
[3] 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 North Macedonia, State Statistical Office, Ministry of Finance, World Bank, Eurostat, International Monetary Fund