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Republic of Macedonia

March 2018

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

- (ns) – not solicited rating

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"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.

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Key developments:

Political situation in Macedonia indicates signs of stabilization. The early parliamentary elections, held on the 11 of December 2016, became a cornerstone of the country's upcoming political development. The leading parties - VMRO-DPMNE and SDSM - achieved similar results, which implied a complex dialogue with the following Albanian ethnic parties to form a coalition government.

The new cabinet is formed with the mandate of the SDSM and the support of some of the Albanian parties represented in the parliament. Among the concessions that Prime Minister Zoran Zaev made to ethnic Albanian parties in return was the adoption of the Law on the Use of Languages to recognize Albanian as the second official in the country and to regulate its use in public sphere. The debate on the law raises some tensions in society, affecting the delicate balance of interethnic relations in Macedonia. Some of the articles in it are criticized as unconstitutional. President Ivanov vetoed it with similar arguments.

The law on languages, on the other hand, complies with the Ohrid Agreement as well as it is part of the internal reforms for a faster process of European integration of the country - a major goal in front of Zaev's cabinet.

The efforts on the new course of the SDSM-led government especially in foreign policy are aimed precisely at the beginning of the negotiation process with the European Union. Macedonia got EU candidate status in 2005, but Greece has been blocking the start of negotiations since then. This is largely result of ongoing disputes over the country's official name. The NATO membership of Macedonia is blocked by the same reasons. Under the 1995 agreement between the authorities of Skopje and Athens, the Republic of Macedonia can join international organizations through the temporary name - the Former Yugoslav Republic of Macedonia.

Over the recent months, the dialogue between Skopje and Athens enhances. Prime Minister Zaev has allowed Macedonia to accept a new name with a geographic qualifier to the name of the republic to become part of NATO as soon as possible. There is an expectation that the naming disputes are going to be finalised at the upcoming NATO Summit in Brussels in July. The long-awaited *Treaty for Friendship, Good Neighbourly Relations and Cooperation between the Republic of Bulgaria and the Republic of Macedonia* is now a fact.

European institutions' asses positively the aforementioned actions of the government. According to the European Commission, *Macedonia is making significant progress on their European path and the Commission is ready to prepare recommendations to open accession negotiations*[1]*.* The 2019th year was mentioned as a possible starting date for the process.

Macedonian authorities got a confidence vote for their policy during the local elections October 2017. The vote confirmed the results from the parliamentary election, which were expectedly not recognised by the opposition VMRO-DPMNE. SDSM won a landslide victory.

Hence, the main challenges Macedonia is confronting, include affirmation of the democratic principles in country's governing as well as further stabilization of relations among the Balkan countries.

The whole political development has left its mark on the economy. Following a slowdown to 2.9% in 2016, real **GDP** contracts to an average of −0.4% in the first three quarters of 2017 affected by the prolonged political crisis. Modest economic growth of 0.2% is registered in the third quarter of the year.

Economic activity is supported by private consumption and exports, while negative effects from the political instability have restrained both private and government investment. Exports remain robust, increasing by 8.1% in real terms, while imports' growth markedly decelerates to 6.7% (13.4% growth in the same period of 2016).

Gross value added marks a real decrease of 0.5% in the first nine months of 2017, compared to 3.0% growth in same prior year period. Agriculture and services sectors have positive contribution to GVA growth, while construction and industry experience drop in activity.

Macedonia trades most actively with the European Union. The share of the trade with the EU

[1] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Strasbourg, 06.02.2018.*

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continues to increase, reaching 81.1% of total exports and 62.9% of total imports in 2017. Germany is the most important trade partner of the country, accounting for almost half of the exports (47%) and 11.8% of country's imports in 2017.

The overall movement of **the trade of goods** during 2017 indicates positive dynamics in nominal terms for both exports and imports. The trade structure according to the SITC sections remains similar to 2016 with strengthening the positions of the leading groups: *Machinery and transport equipment* and *Manufactured goods classified chiefly by material* in exports and imports, respectively.

The current account deficit narrows to EUR 134 million in 2017, accounting for 1.3% of the projected GDP. The deficit decreases by EUR 131 million compared to 2016, due to the higher surplus on the secondary income account, the reduced deficit on the goods account and the increased surplus on the services account, while the deficit on the primary income account marks an increase.

Foreign direct investment inflows in 2017 amount to EUR 228 million, or 2.2% of the projected GDP. Compared to 2016, FDI inflows decrease by 32.8%. Given the already attractive tax regime and financial incentives to foreign firms, strengthening institutions would be key to attracting FDI inflows.

At the end of September 2017, the **gross external debt** stands at EUR 7 710 million, or 75.5% of the projected GDP, which is an increase of 6.8 percentage points against the end of 2016. The share of public external debt in total gross debt increases by 0.4%, but private external debt still prevails with 51.9%. The maturity structure remains favourable, with 72.7% of the total debt being long-term debt.

The sustained minimum volatility of the **MKD/EUR exchange rate** improves the soundness of the country's economic state, but makes it necessary for the country to maintain a high level of **foreign reserves**. Reserves coverage is broadly adequate per various reserve adequacy metrics. The current level of reserves ensures more than 4 months coverage over imports and the coverage of liabilities based on short-term external debt is still above the 100% threshold for adequacy.

The unemployment rate decreases from 23.7% in 2016 to 22.6% in the third quarter of 2017. The unemployment rate, however, remains at alarmingly high levels, much higher than representative EU-members, thus implying the presence of serious structural problems and obstacles standing before the economy.

After remaining negative during the past three years (2014-2016), **inflation** rate, measured by CPI, is picking up reaching 1.4% annual average in 2017. It is mainly driven by the increase of the global oil prices. Inflation pace in medium term will be influenced by the trends of global prices of primary commodities, price trends in the EU, and partially by the economic activity in the national economy.

Central government **budget deficit** in 2017 stands at EUR 274 million, equal to 2.7% of the projected GDP. The general government deficit is slightly higher, standing at EUR 284 million or 2.8% of the projected GDP. Within the constraints of lower than expected revenues, the government under-executed on expenditure, aiming to meet the deficit target in 2017.

Budget deficit for 2018 is planned in the amount of EUR 296 million or 2.7% of GDP. The budget bill envisages 5% higher salaries in healthcare and education and 10% increase of the wages in the army, in line with harmonization to NATO standards. Despite repeated announcements of introducing progressive taxation rates, the proposed personal tax regime change remains on standby.

The **Fiscal strategy** for the period 2018-2020 envisages a gradual fiscal consolidation. The set targets of the fiscal policy provide for reduction of the budget deficit to around 2.5% of GDP in 2019 and 2.3% of GDP in 2020 and balanced primary budget balance at the end of the medium-term period. However, the consolidation plan so far lacks concrete measures.

Although it has been gradually growing since 2009, **general government gross debt** of Macedonia is still below the limit of 60% of GDP adopted by the EU. The ratio may be considered as a positive factor, but the continuous increase in public debt is considered a negative development. Its growth may be a notice of a potential risk related to the government's growing dependence on debt

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issuance as a method of financing its expenditures rather than provide for them with collected revenues.

General government debt stands at EUR 3 958 million at the end of 2017 (38.7%of the projected GDP), while **public debt**[2] stands at EUR 4 787 million, (46.7% of the projected GDP). Guaranteed debt has a share of 17.3% in total public debt.

In terms of currency, round 80% of the general government debt is denominated in foreign currency, mainly in euros (~70% of total public debt). 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.

In the upcoming period, Ministry of Finance will intend to expand the maturity structure of the portfolio of government securities with longer maturities. In order to protect the debt portfolio against the re-financing risk, debt management strategy sets minimum threshold of "average time to maturity" indicator at 3 years in 2018 and minimum threshold of "average time to re-fixing" indicator at 2 years.

In January 2018, Macedonia successfully issued a EUR 500 million **Eurobond** on the international market, with a maturity period of seven years and interest rate of 2.75%. This is the lowest interest rate achieved for any of Macedonia's Eurobonds. Referring to official records, the interest rates of the previously issued five Eurobonds ranged between 3.975% and 9.875%. The Macedonian government last issued a seven-year EUR 450 million Eurobond in July 2016 with a yield of 5.625% and has borrowed only from domestic sources in 2017.

Overall uncertainty in the country also hit the performance of **the banking sector** in 2016 and the beginning of 2017 as the main banking aggregates decelerated. As of Q3 2017, however, certain stabilization is present. Deposits as well as gross loans to the non-financial sector (NFS) grow at moderate pace mainly through the denar-denominated segments meaning a restoring confidence in the domestic currency. Households remain more active than the corporate clients.

Fluctuations in NFS activity are reflected to a lesser extent by the system's qualitative indicators (such as non-performing loan ratio and liquidity), which talks for its resilience to such kind of shocks.

The increases registered in banks' assets, regulatory capital and deposits provides adequate funding for the system while the so far high profitability is slightly reduced three months before the end of the financial year.

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. Despite the latest stabilisation, the political situation still carries some uncertainty, however BCRA do not expect any drastic changes to happen in the short-term.

BCRA would consider **upgrading** the Sovereign Rating and/or improving the rating Outlook for the Republic of Macedonia if the country progresses with the European Union accession. Additional positive effects would be considered the gradual correction in economic imbalances, growth acceleration, improvement in the labour market indicators and implementation of a medium-term fiscal consolidation programme.

BCRA would consider **downgrading** the Sovereign Rating for the Republic of Macedonia in case of renewing of the political instability. Higher fiscal deficit that results in a deterioration of the public debt trajectory, a widening in the current account deficit, further deceleration in economic activity and investments as well as negative shocks to the banking system could also lead to negative rating action.

[2] 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.

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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 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 February 2018.

Summary of the minutes of the Rating Committee:

On the 8th of March 2018 Rating Committee of BCRA – CREDIT RATING AGECY (BCRA) had a cession, 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 constitution of the new government was discussed. The efforts for enhanced cooperation of the country with key international organizations were positively assessed.

The two-year political instability has affected economic activity in the country and by the end of 2017, negative trends are not yet overcome. The members of Committee raised concerns about the stagnation in labour market performance as well as the lessening in the flow of foreign direct investment in the country. The balance of payments current account is improving.

The indicators for public finances remain volatile. The government budget deficit in 2017 remained almost unchanged compared to the previous year. 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.

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Tables:

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

REAL SECTOR							
EUR million[1]	2017 I-IX	2016 I-IX	2016	2015	2014	2013	2012
Gross domestic product	7 369	7 139	9 723	9 072	8 562	8 150	7 585
Final consumption	6 100	5 901	7 987	7 786	7 442	7 274	7 019
Gross capital formation	2 211	2 228	3 169	2 758	2 594	2 348	2 194
Exports	4 090	3 590	4 859	4 422	4 081	3 537	3 442
Imports	5 031	4 581	6 292	5 894	5 555	5 009	5 070
real growth rate (%)							
Gross domestic product	-0,4	2,8	2,9	3,9	3,6	2,9	-0,5
Final consumption	2,1	2,1	2,8	4,3	2,4	1,6	1,4
Gross capital formation	-5,9	18,5	13,3	8,3	10,7	0,5	10,2
Exports	8,1	8,8	8,1	8,5	16,5	6,1	2,0
Imports	6,7	13,4	11,6	9,9	14,1	2,2	8,2
%	2017 Q3	2016 Q3	2016	2015	2014	2013	2012
Unemployment rate[2]	22,1	23,4	23,7	26,1	28,0	29,0	31,0
Activity rate[2]	56,8	56,6	56,5	57,0	57,3	57,2	56,5
Employment rate[2]	44,2	43,4	43,1	42,1	41,2	40,6	39,0
	2017 I-XII	2016 I-XII	2016	2015	2014	2013	2012
Average net monthly wage (EUR)	372	363	363	356	347	343	340
GDP per capita (EUR)	-	-	4 738	4 358	4 122	3 926	3 657
Inflation (CPI; annual average %)	1,4	-0,2	-0,2	-0,3	-0,3	2,8	3,3
MKD/EUR - period average	61,57	61,60	61,60	61,61	61,62	61,58	61,53
MKD/USD - period average	54,67	55,69	55,69	55,50	46,44	46,40	47,90

EXTERNAL SECTOR							
EUR million[1]	2017 I-XII	2016 I-XII	2016	2015	2014	2013	2012
Current account	-134	-265	-265	-177	-43	-134	-240
Current account (% of GDP)[3]	*-1,3*	*-2,7*	*-2,7*	*-2,0*	*-0,5*	*-1,6*	*-3,2*
Goods	-1800	-1809	-1809	-1823	-1856	-1863	-2008
Services	400	347	347	349	384	375	309
Primary income	-424	-384	-384	-286	-161	-193	-164
Secondary income	1691	1581	1581	1583	1589	1547	1622
Capital account	7	11	11	7	3	15	9
Financial account	-149	-266	-266	-172	-27	-107	-212
Net errors and omissions	-22	-12	-12	-2	13	13	19

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EUR million[1]	2017 Q3	2016 Q3	2016	2015	2014	2013	2012
Gross external debt	7710	7489	7217	6291	5992	5220	5172
Gross external debt (% of GDP)[3]	*75,5*	*77,0*	*74,2*	*69,3*	*70,0*	*64,0*	*68,2*
NIIP	-5 971	-5 473	-5 576	-5 083	-4 549	-4 558	-4 178
NIIP (% of GDP)[3]	*-58,3*	*-56,3*	*-57,3*	*-56,0*	*-53,1*	*-55,9*	*-55,1*
Official reserve assets	2 271	2 699	2 613	2 262	2 436	1 993	2 193
Official reserve assets (% of GDP)[3]	22,2	27,8	26,9	24,9	28,5	24,5	28,9
PUBLIC FINANCE							
EUR million[1]	2017 I-XII	2016 I-XII	2016	2015	2014	2013	2012
General government revenue	3 108	2 951	2 951	2 809	2 543	2 450	2 432
General government expenditures	3 392	3 209	3 209	3 120	2 904	2 775	2 727
General government budget balance	-284	-258	-258	-312	-361	-325	-296
General government gross debt	3 958	3 852	3 852	3 453	3 262	2 772	2 554
Public debt	4 787	4 711	4 711	4 227	3 921	3 281	2 909
% of GDP[3]							
General government revenues	30,3	30,3	30,3	31,0	29,7	30,1	32,1
General government expenditures	33,1	33,0	33,0	34,4	33,9	34,1	36,0
General government budget balance	-2,8	-2,7	-2,7	-3,4	-4,2	-4,0	-3,9
General government gross debt	38,7	39,6	39,6	38,1	38,1	34,0	33,7
Public debt	46,7	48,5	48,5	46,6	45,8	40,3	38,3
BANKING SYSTEM							
ratios	2017 Q3	2016 Q3	2016	2015	2014	2013	2012
Capital adequacy ratio	16,2	15,7	15,2	15,5	15,7	16,8	17,1
Liquid assets/ Total assets	27,0	27,1	28,9	28,2	29,8	31,2	32,4
Highly liquid assets/ Total assets	22,9	24,4	25,7	24,3	25,5	27,3	29,4
Non-performing loans/ Total loans (non-financial sector)	6,6	7,4	6,6	10,8	11,3	11,5	10,5
EUR million[4]							
Total (gross) loans (to non-financial entities)	4644	4449	4570	4506	4115	3741	3516
Total deposits (of non-financial entities)	5199	4921	5250	4971	4668	4215	3990
Total assets	7169	6890	7233	6878	6511	6007	5738
Financial result (net profit/ loss)	75	81	103	75	51	38	24

[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] 2017 data are calculated on the basis of GDP amounting to MKD 630 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.