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Republic of North Macedonia

March 2019

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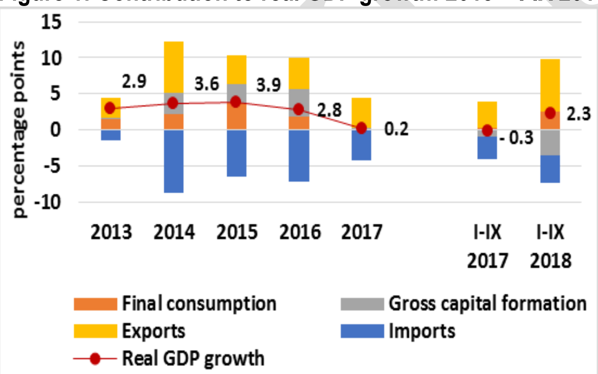
Overview:

Macedonian authorities remain engaged in taking the steps towards Euro-Atlantic integration of the country. Through signing the Agreement from Prespa (June 2018), solving the long-lasting name dispute between Skopje and Athens was commenced. Defining of a mutually recognized name for the former Yugoslav republic was one of the preconditions for Macedonia to start accession talks with NATO once the country had been invited in July 2018. Macedonian Parliament adopted the constitutional changes arising from the Prespa Agreement and gradually implemented them in the legislation thereafter. From the Greek side, the Agreement was approved in end-January 2019, followed by unblocking the Macedonian bid for NATO membership and becoming the first among the NATO countries to ratify the accession protocol. Under its new name North Macedonia is expected to become the 30th member of the alliance in 2020.

On February 12, 2019, the Prespa Agreement entered into force and from now on the country is officially renamed as Republic of North Macedonia, thus, paving their way towards a broader international cooperation. European Union and United Nations welcomed the news. Previously the Council of the EU had responded by stating that Macedonia would be able to open accession talks in June 2019[1].

Figure 1: Contribution to real GDP growth: 2013 – I-IX 2018



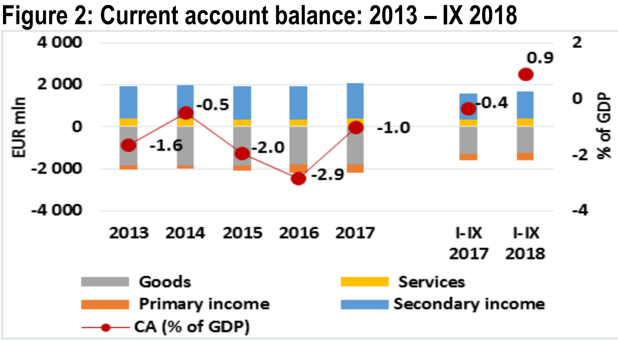
Source: State Statistical Office

The stabilisation of the political environment supports the **economic activity**. Following the stagnation in 2017, economic activity rebounded in the course of 2018, most notably in the second and third quarter of the year, thus, the average real GDP growth in the first nine months of 2018 reached 2.3%.

Consumption and net exports were the growth drivers on the expenditure side, while investments had a negative contribution. Final consumption growth accelerated to 3.1% in the first three quarters of 2018, being supported both by private and public consumption growth. Private consumption increased by 2.3% on an annual basis, backed by employment gains and household credit growth, while public consumption grew by 6.7%, due to increased execution of public expenditures for goods and services. However, the other domestic demand component - investments continued to contract. Gross capital formation decreased by 11.3% in the first nine months of 2018, amid falling construction and lower execution of public capital expenditures. Exports growth markedly accelerated to 12.9% in real terms, while imports experienced lower growth rate of 5.7%, largely reflecting the subdued investment. As a result, net exports had a significant positive impact on the GDP growth.

Analysed by **sectors**, gross value added increased by 2.4% in the first nine months of 2018, backed by positive developments in services and industry sectors, while construction and agricultural sectors contributed negatively to the growth. Overall growth in the services sector amounted to 4.0% in real terms and was driven mostly by higher activity in trade, transportation and food and accommodation services. The value added in industry sector grew by 3.1% on an annual basis. The activity in the agriculture sector continued to decline, however, at lower annual rate of 7.4%, while the drop of activity in construction sector intensified to 7.6% in real terms, hence weighing down the value added growth in the first three quarters of the year.

Figure 2: Current account balance: 2013 – IX 2018



Source: NBRNM

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

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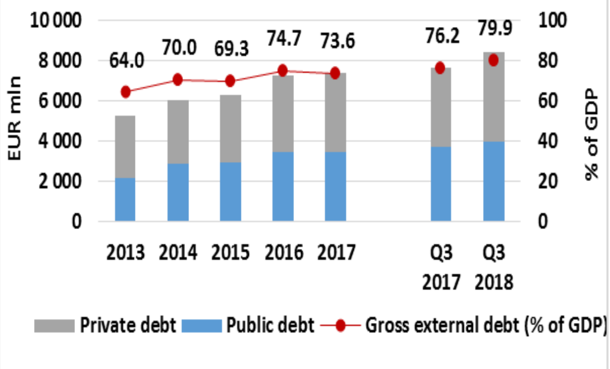
External vulnerabilities remain contained as the **current account** deficit has remained moderate in recent years. In 2017, it stood at 1.0% of GDP, down from 2.9% in 2016. In the period January – September 2018, the current account posted a surplus in the amount of EUR 91 million (0.9% of the projected GDP), as opposed to a EUR 37 million (-0.4% of GDP) deficit in the same period of 2017. The balance improvement was related to the continued improvement in the balance in trade of goods and services, as well as the higher secondary income surplus, while primary income deficit expanded on an annual basis. Over the medium-term, the current account deficit is expected to gradually increase as investment-related imports expand again.

Foreign direct investments in the country mark a solid acceleration, amid the stabilization of the domestic political situation. Net FDIs in the first nine months of 2018 amounted to EUR 310 million (2.9% of the projected GDP), compared to only EUR 11 million (0.1% of GDP) in the same prior year period. Higher FDIs could lift 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. Macedonia ranked 10th in the latest **Doing Business Report** of the World Bank and is the top performer from Southeast Europe. The country is best ranked in the area of Protecting minority investors (7th rank), Getting credit (12th rank), and Dealing with construction permits (13th rank). However, allegations of widespread corruption and insufficient administrative service continue to hamper business operations. Improved governance, better trade logistics and infrastructure are key for enabling a higher level of steady FDI inflows in Macedonia.

Figure 3: Gross external debt: 2013 – Q3 2018



Source: NBRNM

At the end of the third quarter of 2018, **gross external debt** stood at EUR 8 400 million or 77.6% of the projected GDP. Compared to the end of 2017, external debt increased by 13.9% in nominal terms reflecting the growth in both public (15.2%) and private (12.9%) sector debt. As a result, the relative share of public debt in gross external debt picked up by 0.5 p.p. to 47.5%, but private external debt continued to prevail in structure with 52.5%.

At the end of September 2018, Macedonia's negative **net international investment position** stood at EUR 6 031 million (56.5% of the projected GDP), slightly deteriorating in nominal terms from EUR -5 823 million (58.1% of GDP) at the end of 2017, due to faster increase in external liabilities compared to the increase in assets. The negative external position is typical for a developing country and is assessed to be broadly in line with Macedonia's economic fundamentals, as most of the NIIP composition consist of net liabilities on direct investments.

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 high level of **foreign reserves**. At the end of 2018, official foreign reserves equalled to EUR 2 867 million (26.8% of the projected GDP), which represented an increase of 22.7% compared to the end of 2017. Rise in reserves during the year was a result of regular NBRNM foreign exchange purchases, as well as successful issuance of a 7-year EUR 500 million Eurobond in January 2018. The level of foreign reserves remains adequate, providing about 4 months coverage of average imports.

Labour market dynamics are characterized by rise of employment and reduction of unemployment. In the third quarter of 2018, employment rate reached 45.1%, while the pool of unemployed decreased to 20.8% of the active population (from 22.1% a year earlier). The unemployment rate, however, remains at alarmingly high levels, much higher than representative EU-members, whilst the economic activity - respectively lower (57.0% in Q3 2018). This implies the challenging character of unemployment for Macedonian economy.

Average **net wage** in the economy kept its upward movement, increasing in real terms by 3.9% on an annual basis, compared to 1.4% in Q3 2017, with

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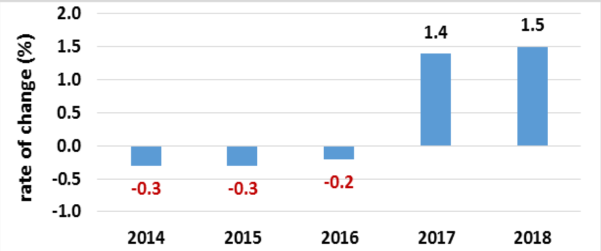
the best paid employees at the sector of Information and communication.

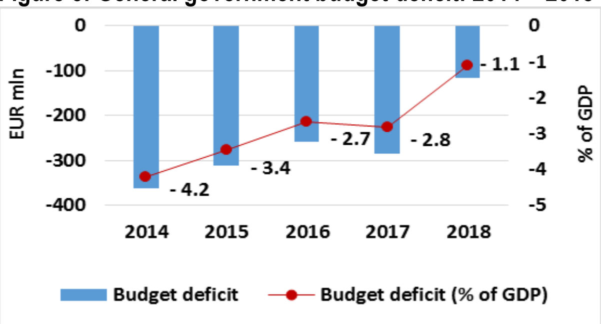
Figure 4: CPI – annual rate of change: 2014 - 2018



Source: State Statistical Office

In 2018, Macedonia recorded annual average **inflation** rate (measured by CPI) of 1.5%, slightly up from 1.4% in 2017. Price level during the year was determined mainly by higher transport prices, as well as higher prices of food, alcoholic beverages and tobacco.

Figure 5: General government budget deficit: 2014 – 2018



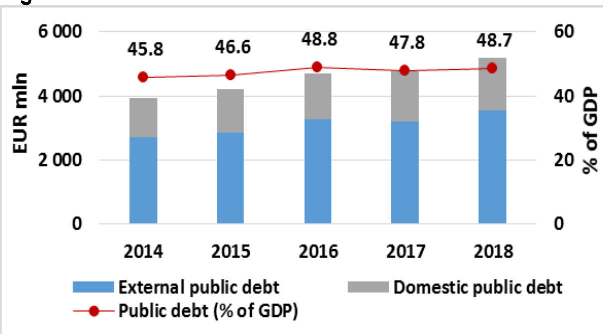
Source: Ministry of Finance

At the end of 2018, consolidated fiscal deficit amounted to EUR 116 mln or 1.1% of the GDP projected, compared to EUR 284 million or 2.8% of GDP in 2017. The fiscal result was also significantly lower than the envisaged deficit target of 2.7% of GDP, mostly due to spending under-execution.

In 2018, consolidated budget revenues recorded 5% annual growth, driven by 8.4% higher collection of tax revenues and social contributions, while non-tax revenues and foreign donations experienced lower collection. Consolidated budget expenditures recorded a nominal decrease of 0.4% relative to 2017, which was mostly attributable to the large under-execution of capital expenditures and goods and services spending. Positive trend was recorded in the interest expenditures, which decreased by 8.4% in nominal terms to 1.2% of GDP, against 1.4% of GDP in 2017.

The continuous increase in **public debt** since the financial crisis has limited the fiscal policy space to counter shocks and address long-term needs, thus, a stronger and sustained fiscal consolidation is needed to put public debt firmly on a downward path.

Figure 6: Public debt: 2014 - 2018

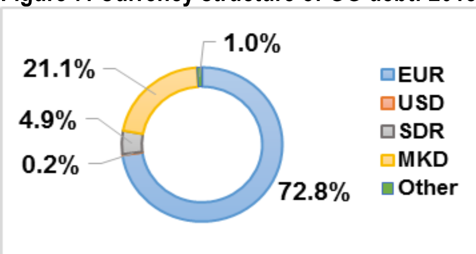


Source: Ministry of Finance

General government debt of the Republic of North Macedonia increased from EUR 3 958 million (39.5% of GDP) in 2017 to EUR 4 344 million (40.7% of the projected GDP) at the end of 2018. Public debt, which includes both the government debt and the guaranteed debt, stood at EUR 5202 million (48.7% of the projected GDP), increasing by EUR 415 million compared to the end of 2017. Guaranteed debt amounted to EUR 858 million or 16.5% of total public debt.

In 2018, the relative share of external public debt increased by 1.4 p.p. to 68% in total public debt, while the share of domestic debt dropped to 32%, respectively. The registered increase of the share of the external debt was a result mainly of the predominant borrowing on the external markets during the year. 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%, the lowest rate achieved so far.

Figure 7: Currency structure of GG debt: 2018



Source: Ministry of Finance

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The interest structure of public debt portfolio continued to improve, as the relative share of debt with fixed interest rate coupons reached 76.9% in general government debt at the end of 2018, compared to 72.3% in 2017. In terms of currency, 78.9% of total government debt in 2018 was denominated in foreign currency, predominantly in euros. The high share of debt denominated in foreign currency could affect the repayment costs, however, the risk of devaluation is low given the fact that the denar is informally pegged to the euro.

According to the Revised Fiscal Strategy 2019-2021, a moderate increase of the total public debt is expected in the medium term - to 54.5% of GDP in 2020, followed by a decline to 53.2% of GDP in 2021.

Over the last six months (Q2 - Q3 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. With the increase of credit activity, the ratio of non-performing exposures further lowered to the historical low of 5.0% as of Q3 2018 (6.6% for Q3 2017). An improvement of the financial result (even the small-sized banks), backed by notably decreased impairments costs, has been observed, accordingly. The total capital adequacy ratio of the system reached 16.3%.

The NBRNM reacted with monetary policy easing. The **key policy rate** was cut three times in 2018 to reach the level of 2.50% (December 2018; 3.25% in December 2017) 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 domestic political scene which has resulted in a pickup in economic activity and the material progress towards NATO and EU membership as the name dispute with Greece has been successfully resolved. However, the rating remains constrained by 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;
- Implementation of a medium-term fiscal consolidation 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:
- Renewed political uncertainty
- Fiscal metrics deterioration;
- Capital outflows related to deterioration of investors' sentiment;
- Pressure 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 February 2019.

Summary of the minutes of the Rating Committee:

On the 28th of February 2019 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 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 resolution of the name dispute with Greece was positively evaluated. Other key points discussed by the Rating Committee were:
- Country's path towards NATO and EU membership;
- The restored political stability;
- The economic activity in the country;
- External balances;
- The long-standing peg of denar to the euro, backed by adequate foreign reserves;
- Government budget execution
- The structure of government debt.
- The dynamics of the banking system indicators, which demonstrate favourable levels, as well as the recovery of the credit activity of the non-financial sector.

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							
	2018 I-IX	2017 I-IX	2017	2016	2015	2014	2013
Gross domestic product (real growth rate)	2.3	-0.3	0.2	2.8	3.9	3.6	2.9
Gross domestic product (EUR mln)	7 813	7 304	10 014	9 657	9 072	8 562	8 150
Final consumption	6 291	5 981	8 091	7 952	7 786	7 442	7 274
Gross capital formation	2 355	2 260	3 303	3 139	2 758	2 594	2 348
Exports	4 684	4 090	5 548	4 892	4 422	4 081	3 537
Imports	5 517	5 028	6 927	6 327	5 894	5 555	5 009
Unemployment rate[1] (%)	20.8*	22.1*	22.4	23.7	26.1	28.0	29.0
Average net monthly wage (EUR)	390	370	372	363	356	347	343
GDP per capita (EUR)	-	-	4 827	4 659	4 382	4 141	3 948
CPI - annual average rate (%); (last 12 months)	1.7	0.8	1.4	-0.2	-0.3	-0.3	2.8
MKD/EUR - period average	61.52	61.59	61.57	61.60	61.61	61.62	61.58
MKD/USD - period average	51.51	55.48	54.65	55.69	55.50	46.44	46.40

EXTERNAL SECTOR							
EUR million	2018 I-IX	2017 I-IX	2017	2016	2015	2014	2013
Current account	91	-37	-103	-276	-177	-43	-134
Goods	-1265	-1284	-1788	-1813	-1823	-1856	-1863
Services	405	323	377	341	349	384	375
Primary income	-326	-301	-398	-384	-286	-161	-193
Secondary income	1277	1226	1706	1581	1583	1589	1547
Foreign direct investments, net	310	11	180	317	203	197	229
Gross external debt	8400	7628	7372	7217	6291	5992	5220
Net international investment position	-6 031	-5 826	-5 823	-5 576	-5 083	-4 549	-4 558
Official reserve assets	2 709	2 271	2 336	2 613	2 262	2 436	1 993
% of GDP[2]							
Current account	0.9	-0.4	-1.0	-2.9	-2.0	-0.5	-1.6
Goods	-11.8	-12.8	-17.9	-18.8	-20.1	-21.7	-22.9
Services	3.8	3.2	3.8	3.5	3.8	4.5	4.6
Primary income	-3.1	-3.0	-4.0	-4.0	-3.2	-1.9	-2.4
Secondary income	12.0	12.2	17.0	16.4	17.4	18.6	19.0
Foreign direct investments , net	-2.9	-0.1	-1.8	-3.3	-2.2	-2.3	-2.8
Gross external debt	80	76	74	75	69	70	64
Net international investment position	-56.5	-58.2	-58.1	-57.7	-56.0	-53.1	-55.9
Official reserve assets	25.4	22.7	23.3	27.1	24.9	28.5	24.5

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PUBLIC FINANCE

EUR million	2018	2017	2016	2015	2014	2013
General government revenues	3 265	3 108	2 951	2 809	2 543	2 450
General government expenditures	3 382	3 392	3 209	3 120	2 904	2 775
General government budget balance	-116	-284	-258	-312	-361	-325
General government debt	4 344	3 958	3 852	3 453	3 262	2 772
Guaranteed debt	858	828	860	774	659	510
Public debt	5 202	4 787	4 711	4 227	3 921	3 281
External public debt	3 538	3 188	3 286	2 848	2 725	2 079
Domestic public debt	1 664	1 599	1 425	1 380	1 196	1 203
% of GDP[2]						
General government revenues	30.5	31.0	30.6	31.0	29.7	30.1
General government expenditures	31.6	33.9	33.2	34.4	33.9	34.1
General government budget balance	-1.1	-2.8	-2.7	-3.4	-4.2	-4.0
General government debt	40.7	39.9	39.9	38.1	38.1	34.0
Guaranteed debt	8.0	8.9	8.9	8.5	7.7	6.3
Public debt	48.7	48.8	48.8	46.6	45.8	40.3
External public debt	33.1	34.0	34.0	31.4	31.8	25.5
Domestic public debt	15.6	14.8	14.8	15.2	14.0	14.8

BANKING SYSTEM

ratios (%)	2018 Q3	2017 Q3	2017	2016	2015	2014	2013
Capital adequacy ratio	16.3	16.2	15.7	15.2	15.5	15.7	16.8
Liquid assets / Total assets	27.3	27.0	27.1	28.9	28.2	29.8	31.2
Highly liquid assets / Total assets	22.7	22.9	23.2	25.7	24.3	25.5	27.3
Non-performing loans/ Total loans (non-financial sector)	5.0	6.6	6.3	6.6	10.8	11.3	11.5
Return on assets (ROA)	2.2	1.4	1.4	1.5	1.1	0.8	0.6
Return on equity (ROE)	19.5	12.6	13.5	13.6	10.4	7.4	5.7
Total assets / GDP	75.0	72.4	74.9	74.8	75.8	75.9	73.6
EUR million[3]							
Total (gross) loans (to non-financial entities)	5 027	4 642	4 839	4 570	4 506	4 115	3 741
Total deposits (of non-financial entities)	5 763	5 197	5 518	5 250	4 971	4 668	4 215
Total assets	7 892	7 166	7 513	7 233	6 878	6 511	6 007
Financial result (net profit/ loss)	124	75	107	103	75	51	38

[1] Population aged 15 years and over; * as of Q3 2018 and Q3 2017
[2] 2018 data are calculated on the basis of GDP amounting to EUR 10 679 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