# Political uncertainty could undermine growth

## The recovery in 2Q21 seems to have been short-lived as negative sentiment is again prevailing. Stubbornness of the pandemic, supply-side bottlenecks affecting the global car industry and elevated local political uncertainty weighing on investments are factors behind our decision to slightly trim this year's and next GDP growth forecasts. This year's budget gap will likely be lower than budgeted due to strong VAT intake and unrealistic capex plan. We deem MoF's mid-term budget targets as ambitious, relying heavily on strong growth figures.

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**Forecasts Overview**

| Economy | 2021f | 2022f |
|---|---|---|
| Real GDP growth (%) | 3.5 | 3.5 |
| Unemployment (%) | 16.1 | 16.1 |
| CPI (%), average | 3.1 | 2.6 |
| Budget balance (% GDP) | -5.6 | -4.5 |
| Public debt (% of GDP) | 61.1 | 61.9 |
| Current account (% GDP) | -3.3 | -3.1 |

*Source: Erste Group Research*

| Ratings | Current | Outlook |
|---|---|---|
| S&P | BB- | stable |
| Fitch | BB+ | negative |

*Source: Bloomberg*

| General | 2021f |
|---|---|
| Population (in mn) | 2.1 |
| GDP/Capita EUR | 5,592 |

*Source: Erste Group Research*

**Note:**
**Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.*

- After a weak start to 2021 growth bounced back in 2Q rising 13.1% y/y, thus averaging 5.2% y/y growth in 1H21. Growth was underpinned by revived domestic demand developments, notably unleashed household consumption, while net external contribution to growth was negative. High-frequency indicators suggest slowdown of growth in 2H21.
- Real retail trade activity remains in good shape with yearly prints in double-digit area, but w-d-a industrial production is under pressure due to global supply chain bottlenecks, as it declined in both July and August, despite low base effects. External trade developments will contribute negatively to growth as exports growth of 7% y/y is overturned by surging imports (16.6% y/y) in the period. We see investments, both private and public, slowing further in 4Q after political jitters that followed local elections and likely a protracted period of political uncertainty. Bottom line, we trim this year's and next GDP growth forecasts by 0.3pp and 0.6pp respectively to 3.5% before rising to 4% in 2023.
- Supply side pressures intensified considerably recently. After averaging 3.5% y/y in 3Q, CPI surged to 4.1% y/y in October. The increase was primarily driven by electricity, fuel and food prices. We have revised our average CPI forecast for the year to 3.1% y/y, followed by 2.6% y/y and 1.6% y/y in 2022 and 2023 respectively.
- Overall stock of the C/A gap will likely remain basically unchanged, while relative to GDP the gap could narrow by 0.2pp to 3.3%. Near term external risks are low due to improved international reserve levels, external financing availability, steady inflow on the financial account and extension of the EUR 400mn repo facility with the ECB until March next year.
- The CB maintains an accommodative monetary stance with the policy rate at 1.25% since March. Monetary policy will likely remain accommodative in the upcoming period, absent stronger rise in inflation expectations. The peg of the dinar to the euro remains stable.
- Although the government revised up its budget deficit target to 6.5% of GDP, we forecast the end figure will be below 6% of the GDP courtesy of decent revenue growth and under-execution in planned public investment, especially likely in the last quarter reflecting political wrangling. The government plans to cut the deficit to 3.5% of the GDP by 2023 but consolidation measures remain unclear.
- Political uncertainty has increased following a bad result on local elections for the ruling Social Democrats. After a failed attempt by the opposition to oust the government, the ruling parties are busy trying to bolster their shaky support base in parliament. The blockade by Bulgaria continues to hamper EU accession path.

## Real economy

**Economy bounced back in 2Q after a weak start to the year**

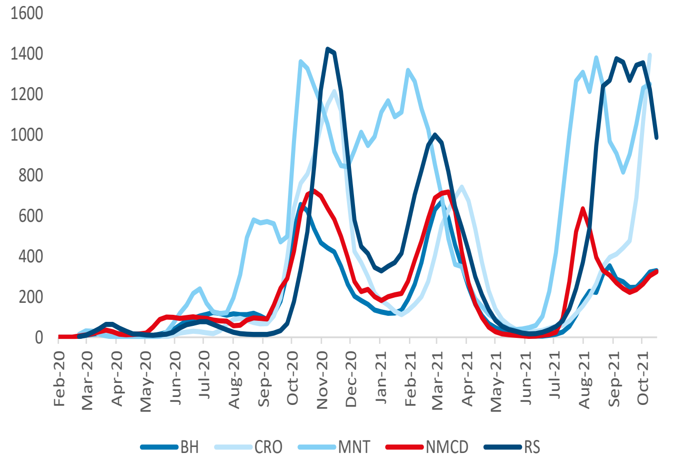
The economy expanded 5.2% y/y in 1H21, after the contraction in 1Q21 (-1.9% y/y) was followed by strong rebound in 2Q21 (13.1% y/y). Private consumption was the key driver of growth in 1H21, rising 6.7% y/y on average. Investments rose only 3.5% y/y in the period notwithstanding low base. Public sector performance in the period was rather neutral. Finally, despite slightly higher average growth of export than imports in the period (24.6% y/y vs 21.2% y/y) external net contribution was negative.

**High-frequency indicators point to a slowdown in growth in 2H21**

The strong recovery observed in 2Q21 seems to have been short lived. Working day-adjusted industrial production recorded marginal declines in both July and August notwithstanding almost double-digit declines in the same period in 2020. Manufacturing performance was a drag, as it fell almost 4% y/y in both months, likely due to global supply chain disruptions. External trade developments also suggest a slowdown. Namely, exports of goods rose 6.9% y/y in 3Q, falling short of surging import growth (16.6%) in the same period. Additionally, in September export of goods even contracted y/y, thus a first contraction in over a year. Retail trade remains a silver lining, continuing with its double-digit growth trend throughout the respective period, albeit coming of low base effects. Still, with stronger than expected both wage growth and remittances intake consumption is poised to remain the engine of the recovery. Given and later retracted resignation of pro-EU PM Zaev suggests a protracted period of political uncertainty. The latter, coupled with recent general instability in the Balkan region, could lead to a slowdown in investments at least until a cabinet reshuffle and the country's commitment towards the EU path is reconfirmed. Notwithstanding the relatively better pandemic situation than elsewhere in the region or in core EU countries, still uncertain evolution of the pandemic as well as global supply disruptions impacting the car industry, among others, could all represent challenges to the tempo of recovery. The government has secured sufficient vaccine doses but only 38% of the targeted population has been vaccinated due to relatively high vaccination hesitancy in the country. In mid-year the government presented a rather optimistic growth acceleration financing plan (GAP) for the period up to 2025 with the purpose of significantly scaling up investments in the country but given the current political situation we have not included the plan in our forecasts for now. Bottom line, we trim our growth forecast by 0.3pp and 0.6pp to 3.5% y/y both in 2021 and 2022, while acceleration of growth to 4% y/y is expected in 2023.

**Covid pandemic not as dramatic as elsewhere**

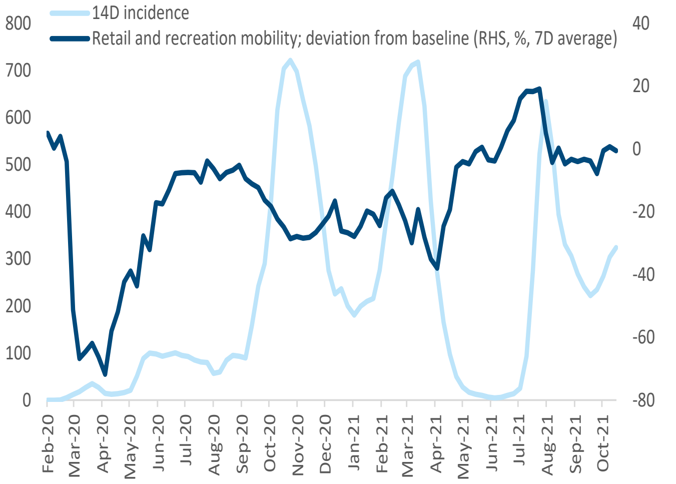
New COVID-19 cases (per 100tsd pop, 14-day rate)




Source: ECDC, Erste Group Research

**No lockdown this time**

14-Day COVID incidence; Retail and recreation mobility

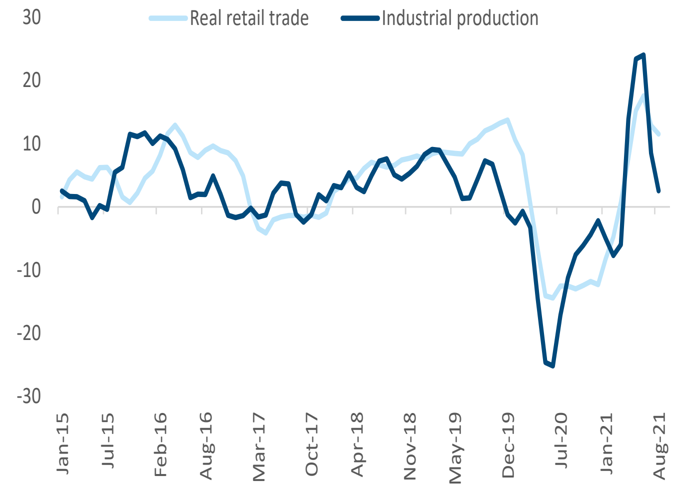



Source: ECDC, Google data, Erste Group Research

**Risks remain to downside**

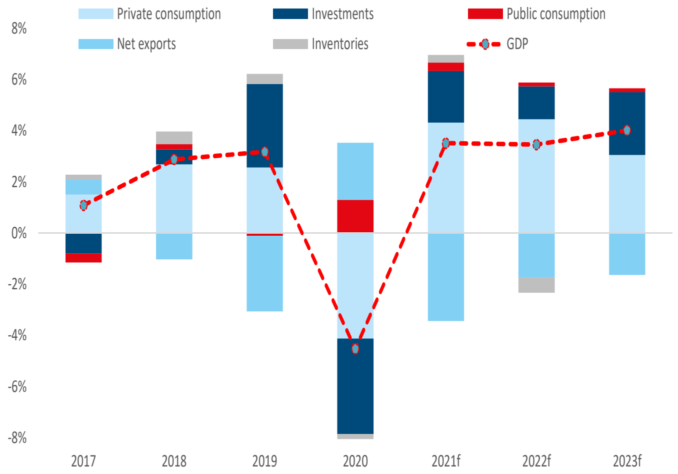
In general, risks to our forecast remain tilted to the downside. The long-lasting nature of the pandemic coupled with hesitancy of the population towards vaccination, unresolved structural bottlenecks in global supply chains affecting local production, negative investor sentiment due to unresolved bilateral dispute with Bulgaria further aggravated with recent local political uncertainty are all factors which cloud the growth outlook. A prolonged delay to securing the date for the opening of negotiations with the EU could not only lead to reduced reform momentum but could also weigh on general support for EU entry, which could be a catalyst for outflows from the country. The latter is not our base case but until there is more political clarity inflows could temporarily freeze.

**High frequency indicators suggest a slowdown in growth**
Real retail trade; Industrial production (y/y, %, 3mma)




Source: Makstat, Erste Group Research

**Domestic demand will remain key positive factor**
GDP contributions

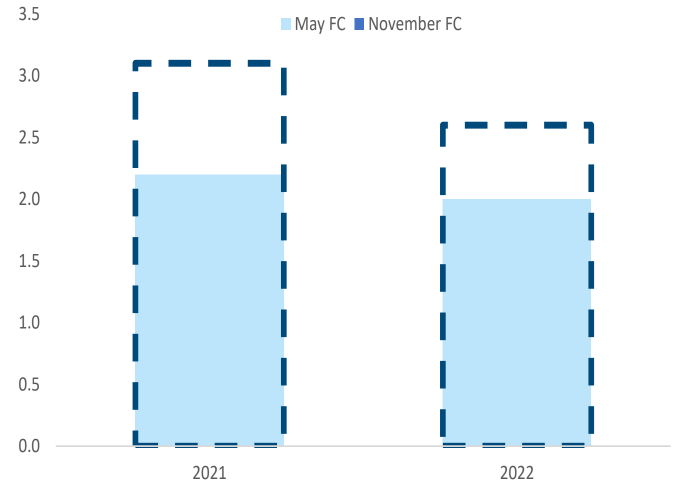



Source: Makstat, Erste Group Research

**Inflation surged in 2H21 due to supply-side pressures**

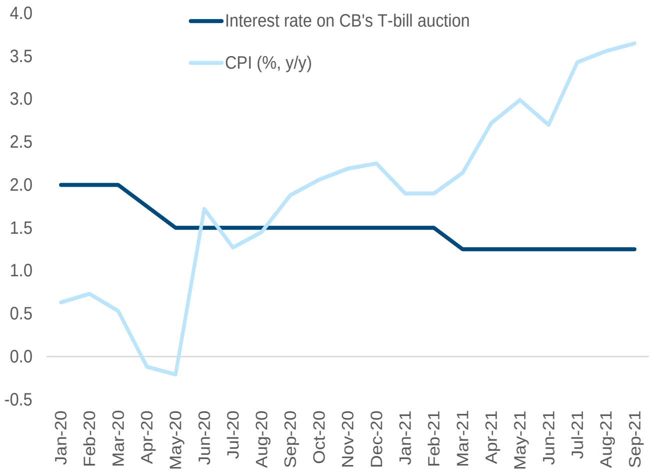
The increase in inflation since the start of the year was driven by food prices, in particular the non-seasonal increase in vegetable prices, energy prices and prices for transport services due to low base stemming from the start of the pandemic. Prices should peak at year end slightly above 4% y/y and then gradually decline in 2022, with a more meaningful decline expected in 2H22. We have revised our average CPI forecast for the year to 3.1% y/y, followed by 2.6% y/y and 1.6% y/y in 2022 and 2023. The main risks relate to commodity prices and tempo of normalization of global supply-chain bottlenecks.

**Significant upside revision to inflation**
Average CPI (in %, y/y)




Source: Makstat, Erste Group Research

**Not much room left for further easing**
Key rate (in %) and CPI (in %, y/y)




Source: Makstat, NBRNM, Erste Group Research

## External position

**Private transfers offset widening trade gap**

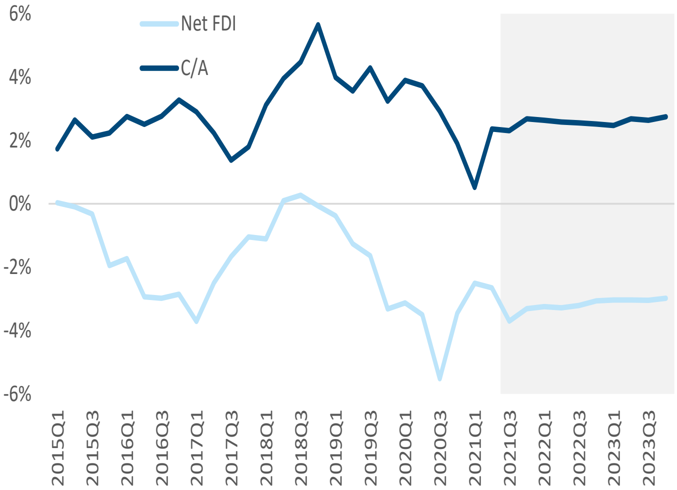
External imbalances narrowed in 1H21, notwithstanding slight widening of the trade gap, owing largely to strong current transfers, i.e. remittances inflow. Namely, the trade gap widened by 1.2pp of the GDP to 17.5% after 1H21 while remittances inflow increased 37% y/y in the same period. Overall, the C/A gap narrowed from 3.5% of GDP at the end of 2020 to 2.7% of GDP after 1H21 (on a 4Q rolling basis). On the financing side, FDI flows picked up in 2Q (2.4% of GDP on a 4Q rolling basis) reflecting stronger inflow into manufacturing sector as well as higher reinvestment of earnings. Ultimately the C/A gap is projected to widen to 3.3% of GDP by year end reflecting worsening trade pattern but overall remain relatively unchanged compared to the end of last year.

**External risks contained**

The stock of gross external debt in 1H21 rose by EUR 1.6bn to EUR 10.2bn (88% of the forecasted GDP), hence 19% increase compared to the end of last year. That said, if we exclude specific central bank activities related to foreign reserve management the increase is EUR 1.2bn. Roughly 60% of the increase is related to March's EUR 700mn bond issuance while EUR 466mn can be linked to the private sector. Things will level out somewhat when we get data for the 3Q as in July an older bond worth EUR 500mn was repaid as it matured. Overall external risks are contained by adequate FX reserve level (32% of the GDP at the end of September and roughly 5 months of imported goods) which guarantees the stability of the exchange rate peg. Additionally, the country has historically run a relatively low C/A gap almost fully covered through FDI inflow. Risks are further mitigated by the extension of the EUR 400mn repo facility with the ECB until March next year.

**C/A gap narrows gradually**

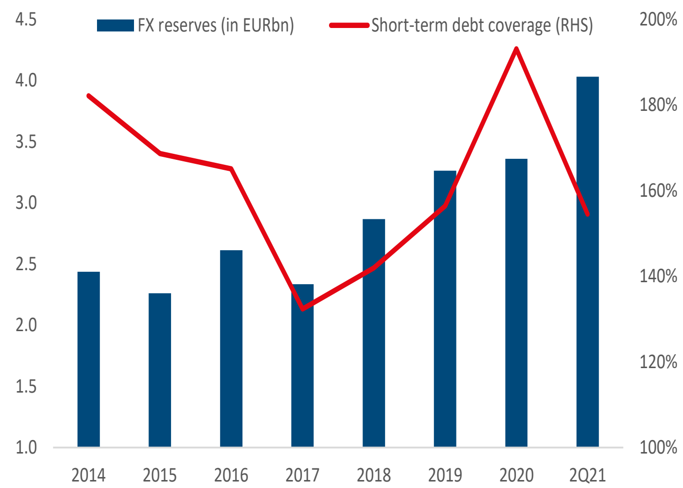
C/A balance and net FDI (in % of GDP)




Source: NBRNM, Erste Group Research

**Reserve stock increased after 1H21**

FX reserves (in EUR bn) and FXR/short-term debt ratio




Source: NBRNM, Erste Group Research

**Refinancing needs in 2022 are relatively low**

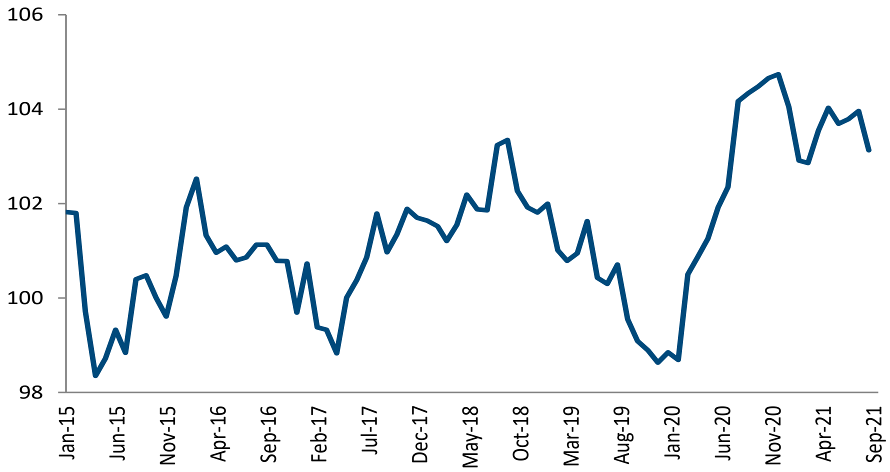
After the July repayment public debt fell to 60.5% of the GDP, thus relatively unchanged compared to the end of last year. In August the IMF allocated EUR 134.5mn in special drawing rights lifting the government's cash buffer to around 6% of the forecasted GDP at the end of September which should be more than enough to cover all refinancing needs by the end of the year. Refinancing needs for next year are relatively low (roughly EUR 400mn) compared to this year (EUR 850mn) and especially compared to 2023 (EUR 1bn) when the next euro bond matures. Given the latter, the country might opt for some external pre-financing next year although considering the current political situation we don't expect to see any issuance until 2H22.

## Monetary and Fiscal Developments

**NBRNM on hold since March**

After cutting the key interest rate to 1.25% on its March meeting, the National Bank of North Macedonia has kept the key interest rate unchanged since. On its most recent meeting in November the CB's policy committee concluded the level is appropriate to the current macro and financial conditions in the country, characterizing inflation pressures as transitory and largely supply side driven and ultimately leaving the stance of the monetary policy relaxed. The peg to the euro remained intact during the crisis. The CB continues to monitor the foreign exchange market daily and has more than enough ammunition to ensure rate stability. As for REER and its effect on overall competitiveness, it seems to have peaked at the end of the year and competitiveness has been improving since, although rather gradually.

**Competitiveness gradually improving in 2021**
REER (index, 2015=100)

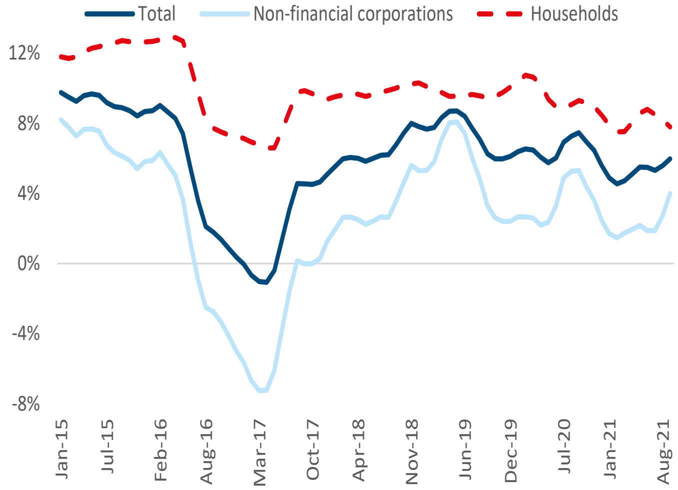



Source: NBRNM, Erste Group Research

**Credit dynamics remained solid**

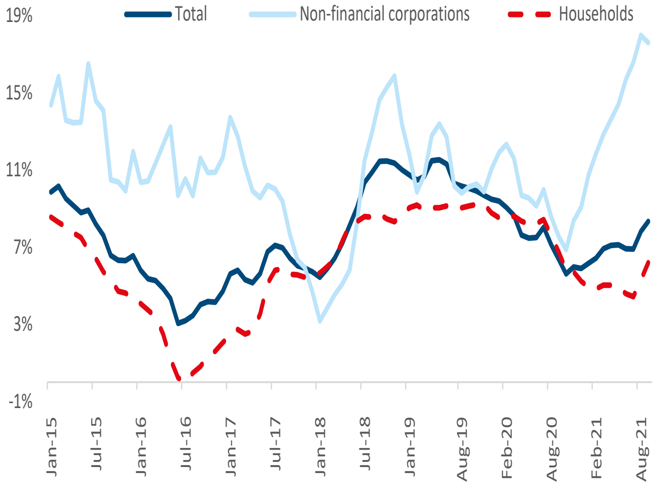
Total credit activity rose 5% YTD in 9M21 underpinned mostly by 6% YTD growth recorded in the household segment, while corporate credit recorded growth of 3.7% YTD. On the liabilities side, the total deposit base grew 4.3% YTD, owing mostly to strong short-term foreign deposit growth both in the corporate and household segment. In general, the banking sector has withstood the crisis well, albeit the full effects of the crisis are yet to be experienced in the aftermath of loan moratorium period. Available data shows banks have managed to increase capitalization after 1H21 compared to the end of last year (17.3% vs 16.7%) and profitability (12.6% ROE vs 11.3%). The share of NPLs in total loans remained relatively unchanged at 3.5% after 1H21 but could worsen somewhat until year end as some loan moratoriums were still being phased out at the time. That said, due to high level of overall capitalization the system is projected to remain stable over the medium term. The central bank removed the ban on dividend distribution in August introduced in February.

**Steady credit activity**
Bank loans to institutional sectors (3mma, y/y)




Source: NBRNM, Erste Group Research

**Corporate deposits surged**
Bank deposits by institutional sectors (3mma, y/y)

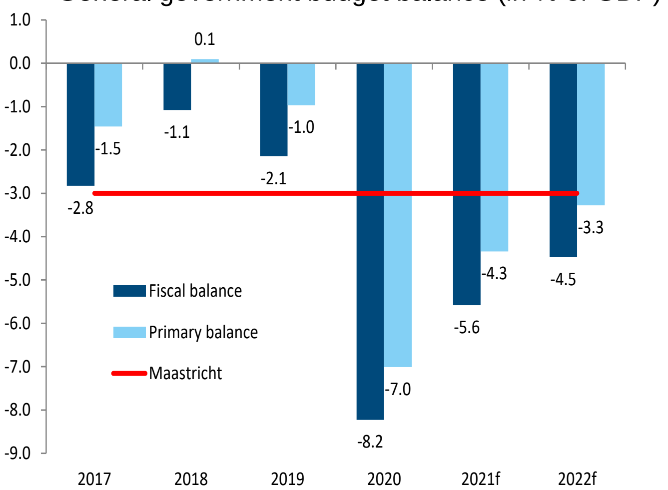



Source: NBRNM, Erste Group Research

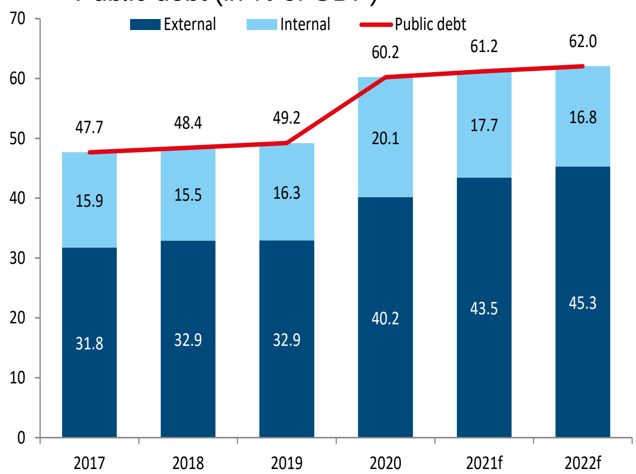
**Debt level continues to float around the 60% mark**

The general government gap after 9M21 stands at roughly 3.3% of the forecasted GDP. Despite the relatively more upbeat trend than envisaged earlier, the MoF rebalanced the budget, lifting the projected gap from 4.9% of the GDP 6.5% of the GDP. In other words, the MoF expect the gap in the last quarter to amount roughly equal to the gap in the first three quarters combined. Given recent political wrangling, and likely delays in various public project implementation, we expect the gap will be lower at around 5.6% of the GDP. Revenues for the first three quarters rose 17.8% y/y due to similar growth in tax intake while expenditures in the same period are up 7.6% y/y, as CAPEX rose 53.2% y/y. The overall public debt level (including guaranteed debt) increased by EUR 467mn in September YTD but remained relatively unchanged in GDP terms, hence around the 60% of GDP mark. Fiscal deficit is expected to decline, albeit only gradually, given the announced plan to ramp up capital spending under the growth acceleration plan. The government plans to reduce the deficit to 3.5% by 2023 but given unclear consolidation measures, optimistically projected growth rates and difficult political situation a deviation from the plan seems likely. After the euro bond tap in March, most of the refinancing needs for the year were secured, while the rest will be met through domestic issuance, credit lines with IFIs and existing fiscal reserves (6.6% of the GDP cash buffer at the end of October). Debt maturity repayments for next year are relatively low at around EUR 400mn but given high repayment needs in 2023 at around EUR 1bn we could expect some pre-financing activity in 2H22.

**Budget gap to remain wide in near term**
General government budget balance (in % of GDP)




**Public debt above 60% of GDP**
Public debt (in % of GDP)



## Politics

**Political jitters followed local elections**

Following a bad result on local elections in November PM Zoran Zaev initially offered his resignation, but after the opposition scheduled a no-confidence vote in parliament, Zaev postponed his announced resignation, saying he will stay on to keep the Social Democrat-led government afloat. The no-confidence vote eventually failed, thus giving the government a fresh boost although the long-term survival depends on success in delivering a start to EU accession talks. A small opposition ethnic Albanian party, Alternative, seems the most plausible choice to replace the equally small Albanian BESA party in the cabinet – after the latter defected. If Alternative does join Zaev's side, its four MPs would strengthen the government's footing in parliament from a shaky 60 MPs out of 120 to a healthier 64. Rumors of other opposition MPs joining the government are also circulating.
The only binding glue between the ruling parties and parties who just a few weeks ago actively worked to oust them – and now seem ready to join them – is a widely felt need not to rock the political boat when the country is struggling to keep its EU agenda alive while also dealing with a health and energy crises.

Looking ahead, a reshuffle of the cabinet is likely, as the new junior partner will likely ask for two ministerial positions. For now, the biggest justification for the ruling Social Democrats and the small ethnic Albanian parties or individual MPs uniting and bolstering the government's majority is the prospect of keeping the EU agenda alive. But while North Macedonia joined NATO last year, progress on the EU front became stuck at the end of 2020, when Bulgaria blocked the start of its long-awaited accession talks, citing a dispute over matters of joint history. Following a lost year in which an unstable Bulgaria was preoccupied with three consecutive elections, the next chance to set things right is the December EU summit, when Bulgaria again is expected to face pressure to ease its stance.

# Forecasts

| Annual | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021f | 2022f | 2023f |
|---|---|---|---|---|---|---|---|---|---|---|
| Nominal GDP (EUR mn) | 8,563 | 9,072 | 9,656 | 10,039 | 10,744 | 11,262 | 10,766 | 11,611 | 12,319 | 13,016 |
| Population (mn) | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| GDP per capita (EUR) | 4,138 | 4,380 | 4,656 | 4,837 | 5,173 | 5,424 | 5,180 | 5,592 | 5,945 | 6,294 |
| | | | | | | | | | | |
| Real GDP (growth y/y %) | 3.6 | 3.9 | 2.8 | 1.1 | 2.9 | 3.2 | -4.5 | 3.5 | 3.5 | 4.0 |
| Private consumption (growth y/y %) | 2.2 | 4.4 | 3.9 | 2.1 | 3.7 | 3.5 | -5.6 | 5.9 | 6.0 | 4.0 |
| Fixed capital formation (growth y/y %) | 10.7 | 8.3 | 12.5 | -2.2 | 1.7 | 9.5 | -10.2 | 5.9 | 3.7 | 7.0 |
| | | | | | | | | | | |
| Nominal gross wages (EUR) | 508 | 522 | 533 | 548 | 579 | 609 | 658 | 692 | 718 | 744 |
| Gross wages growth (%) | 1.0 | 2.7 | 2.0 | 2.6 | 5.7 | 5.1 | 8.0 | 5.2 | 3.8 | 3.6 |
| | | | | | | | | | | |
| CPI (y/y, average %) | -0.3 | -0.3 | -0.2 | 1.4 | 1.4 | 0.8 | 1.2 | 3.1 | 2.6 | 1.6 |
| CPI (y/y, year end %) | -0.5 | -0.3 | -0.2 | 2.4 | 0.9 | 0.4 | 2.3 | 4.0 | 1.0 | 2.0 |
| Unemployment (%) | 28.0 | 26.1 | 23.7 | 22.4 | 20.7 | 17.3 | 16.4 | 16.1 | 16.1 | 15.9 |
| | | | | | | | | | | |
| Trade balance (% of GDP) | -14.9 | -20.1 | -18.8 | -17.8 | -16.2 | -17.6 | -16.8 | -18.5 | -18.6 | -18.7 |
| Current account balance (% of GDP) | -0.3 | -1.9 | -2.9 | -1.0 | -0.1 | -3.3 | -3.5 | -3.3 | -3.1 | -3.0 |
| Net FDI inflow (% of GDP) | 1.6 | 2.2 | 3.3 | 1.8 | 5.6 | 3.2 | 1.9 | 2.7 | 2.5 | 2.7 |
| | | | | | | | | | | |
| General government budget balance (% of GDP) | -4.2 | -3.4 | -2.7 | -2.8 | -1.1 | -2.1 | -8.2 | -5.6 | -4.5 | -4.0 |
| Public debt (% of GDP) | 45.8 | 46.6 | 48.8 | 47.7 | 48.4 | 49.2 | 60.2 | 61.1 | 61.9 | 62.5 |
| Foreign debt to GDP (%) | 70.0 | 69.3 | 74.7 | 73.4 | 73.0 | 72.4 | 79.3 | 80.4 | 81.4 | 81.7 |
| | | | | | | | | | | |
| Long term interest rate (EUR 2025) average | | | | | 2.9 | 1.8 | 2.0 | 1.3 | 1.5 | 1.4 |
| Long term interest rate (EUR 2025) year-end | | | | | 3.2 | 1.4 | 1.2 | 1.7 | 1.3 | 1.4 |
| | | | | | | | | | | |
| EUR/MKD | 61.6 | 61.6 | 61.6 | 61.6 | 61.5 | 61.5 | 61.7 | 61.7 | 61.7 | 61.7 |

**Note:**

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