Growth should accelerate over the medium term

According to available data, recovery in 2024 remains constrained. Underperformance stems from delays in highway construction and slow recovery of key external markets, notably Germany. Growth is projected to accelerate over the forecasted period, but risks are largely to the downside. Headline inflation eased to around 3% but core inflation remains high reflecting wage gains and subsequent price pressures in the service sector. Both the budget gap and debt level remain above the introduced fiscal rules, with only modest narrowing projected. Political power shifted towards the right-spectrum following June's elections. The new coalition led by VMRO-DPMNE should remain stable and maintain a pro-EU policy stance albeit we don't expect a quick fix regarding the bilateral issue with Bulgaria. Hence, progress on the EU path is likely to remain modest at best.

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Forecasts Overview

Economy	2024f	2025f
Real GDP growth (%)	2.0	2.6
Unemployment (%)	12.5	11.9
CPI (%), average	3.3	3.0
Budget balance (% GDP)	-5.0	-4.5
Public debt (% of GDP)	66.8	68.0
Current account (% GDP)	-2.2	-2.8

Source: Erste Group Research

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

Source: Bloomberg

General	2024f
Population (in mn)	1.8
GDP/Capita EUR	7,898

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.*

- Economy expanded 1.8% y/y in 1H24, with growth rate moving above 2% y/y in the 2Q for the first time in two years. Positive impulse came from a drop in imports, thus alleviating external pressures as exports remain muted. On the domestic side, personal consumption slowed compared to 2023 growth pace, but public spending supported growth although possibly due to pre-election spending. After strong positive reading early in the year, largely due to base effect, gross capital formation again contracted in 2Q.
- High frequency indicators suggest some improvement of economic activity in 2H24. Real retail trade activity rose 5.4% y/y on average in 3Q, while industrial production remained in the red, albeit easing its downturn. Trade balance data suggest less of a drag in the quarter as imports declined. We expect a positive impetus from the investment and consumption side going forward. The former benefits from the start of highway construction as issues appear to have been resolved, while the latter benefits from strong real wage growth. Overall, we expect the economy to accelerate 2% y/y this year, and accelerate to 2.6% y/y and 3.3% y/y in 2025 and 2026.
- While headline inflation has come a long way since it peaked in late, easing to 3.5% y/y in October, core inflation remains a source of concern as it landed at 5.9% y/y in the same month. Acceleration of core inflation stems from high wage gains as well a surge in service prices. We expect headline inflation to drop below 3% in 2Q25, and remain there for the rest of 2025.
- After recording a C/A surplus of 0.4% of GDP in 2023, worsening trade balance pushed the C/A into the red, amounting -1.4% of the GDP at 1H24 (on a 4QMA). Given expected widening of the trade gap due to highway related imports and still muted export performance, we expect a deterioration in the mid-term. The gap should remain more than covered by FDI inflow throughout the forecasted period.
- Monetary policy remained on the cautious side longer than elsewhere in the region, with the CB bill interest rate at 6.3% until September. Since then we saw two consecutive 25bps cuts. We expect the central bank to remain cautious given the need to safeguard the peg, offset core inflation pressures and watch for spilovers due to heightened global geopolitical tensions.
- Fiscal consolidation is once again postponed due to pre-election spending related to the former administration but also post-election decision of the new administration to increase pensions and part of public sector wages. Due to subdued growth and high projected budget gaps, public debt to GDP ratio will continue to rise.
- Following their triumphant victory in June elections, right-wing VMRO DPMNE soon formed a coalition government with ethnic Albanian parties. The coalition appears stable and should maintain a pro-EU policy approach albeit, according to early statements, not at all costs.

Real economy

Growth still underwhelming

Slow economic growth observed since 2H22 largely continued throughout 1H24. The economy experienced 1.8% y/y real GDP growth in 1H24. Domestic demand remained weak, with household consumption growth slowing down from 2023 levels, while the positive contribution from investment reflected base effects. Growth largely relied on a steep drop in imports, overcompensating for still muted export performance.

Some improvement observed in 2H24

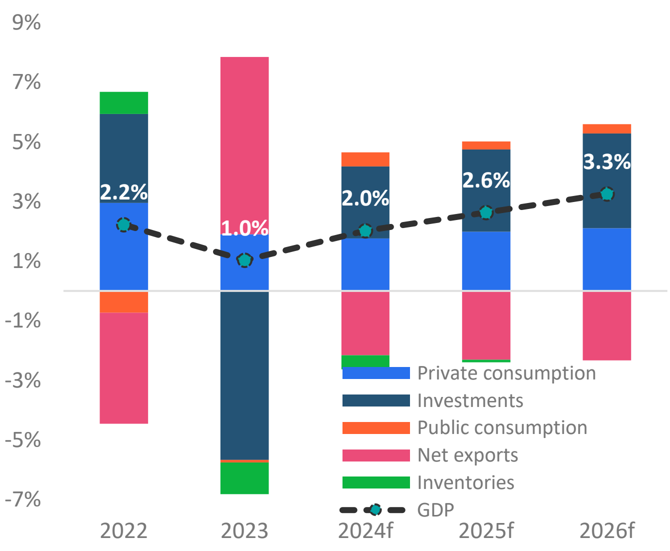
High frequency indicators give some indication that the economy started to accelerate in 3Q, although mostly related to consumption. Real retail trade activity rose 5.4% y/y on average in 3Q, while industrial production remained in the red, albeit easing its downturn. Trade balance data suggest less of a drag in the quarter due to relatively similar contractions on both the export and import side. Despite some slowing, remittances remain an important source of support for the domestic economy, amounting to almost 20% of the GDP each year. Bottom line, we expect 2% y/y average real GDP growth in 2024, thus 0.3pp lower than our expectations in May.

Construction of highway offers upside potential

We expect a positive impetus from the investment and consumption side going forward. The former should benefit from the implementation of a major public road project, covering parts of Trans-European Corridors 8 and 10d, which faced several delays that have been largely resolved and works have begun. The project is valued at EUR 1.3bn (11.5% of 2023 GDP) and works should span over six years. Meanwhile consumption benefits from strong real wage growth, and a new round of pension hikes (in September and March next year) as well as some public sector wage hikes last month. On the external side, net exports are not expected to contribute to growth over the forecast period, against the background of still bleak forecast for the German economy and increasing imports to meet the projected rise in investment. Overall, we expect the economy to accelerate to 2.6% y/y and 3.3% y/y in 2025 and 2026.

Weak external demand weighs on growth

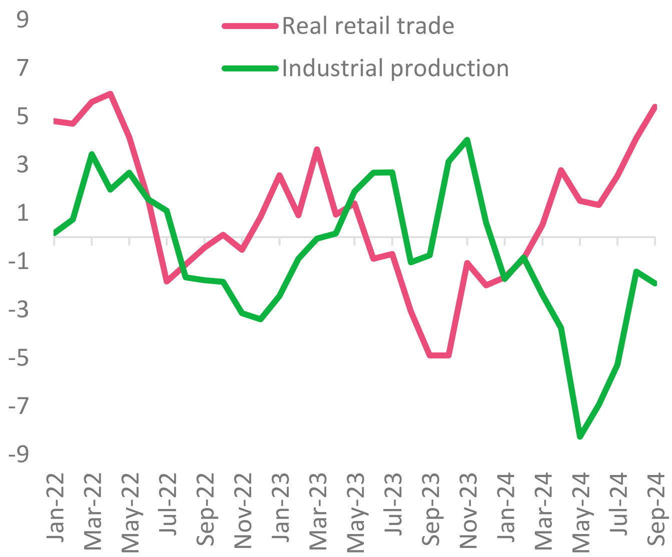
GDP contributions



Source: Makstat, Erste Group Research

Industry still in red, retail activity offers hope

Real retail trade; Industrial production (y/y, %, 3mma)

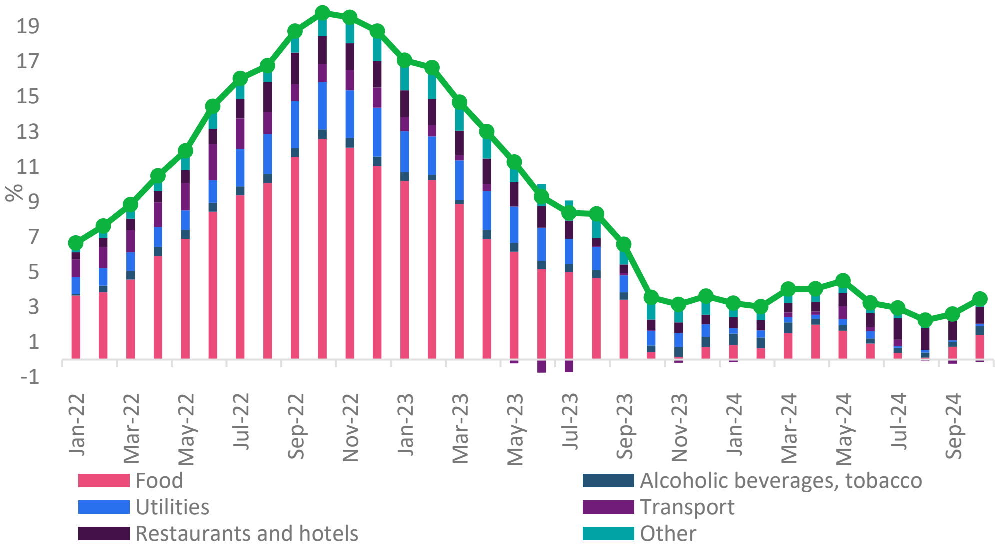


Source: Makstat, Erste Group Research

Core inflation above headline inflation

Headline inflation averaged 3.3% y/y in 10M23, falling as low as 2.2% y/y in August. On the other hand, core inflation averaged 5.2% y/y in the same period, reflecting wage price spiral. In the near-term headline inflation could rise towards 4% y/y, pushed by rising food prices after a poor harvest season. On a longer term perspective, we expect inflation to average 3% y/y over 2025-2026.

Food prices again main driver of inflation
CPI contributions (%)

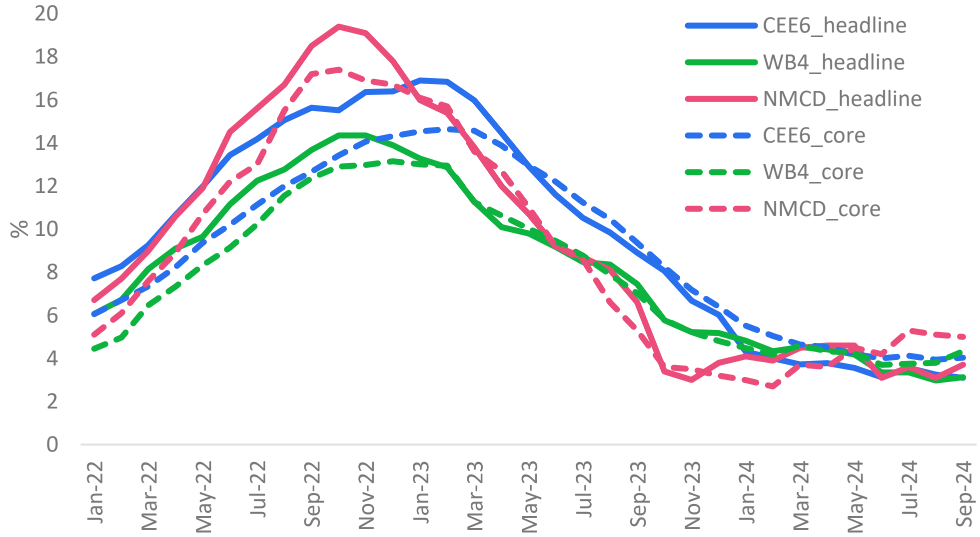


Source: Makstat, Erste Group Research

Slower pace of monetary easing is our base case as core inflation remains sticky

While headline inflation in North Macedonia slowed in line with regional peers, core inflation in 2H24 has been trending roughly 1pp higher than the Western Balkan average, underscoring the impact of price pressure from domestic factors. Given relatively loose fiscal policy at the moment, and continued wage gains not linked to gains in productivity, the pace of monetary easing will likely be slower than elsewhere in the region.

Core inflation above headline inflation
Total HICP and Core HICP (%, y/y)



Source: Eurostat, Erste Group Research

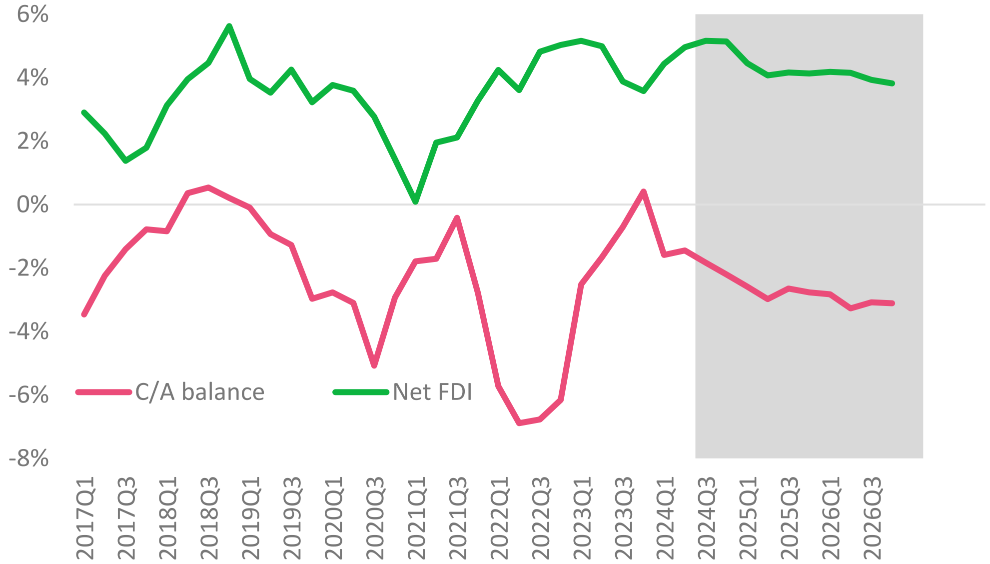
External position

Trade deficit weighs on C/A

Deterioration of the trade balance means the C/A gap moved from a 0.4% of GDP surplus in 2023 to a 1.4% of GDP deficit of the C/A after 1H24. Acceleration of the highway construction could feed imports and weigh further on the trade and consequently C/A balance. Net FDI inflows picked up after a couple of weak quarters and are again around the usual 5% of GDP, hence covering the C/A gap several times. We expect the C/A gap at year-end slightly above 2% of the GDP, and closer to 3% in the next two years.

C/A balance deteriorating again

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



Source: NBRNM, Erste Group Research

Challenging refinancing years ahead

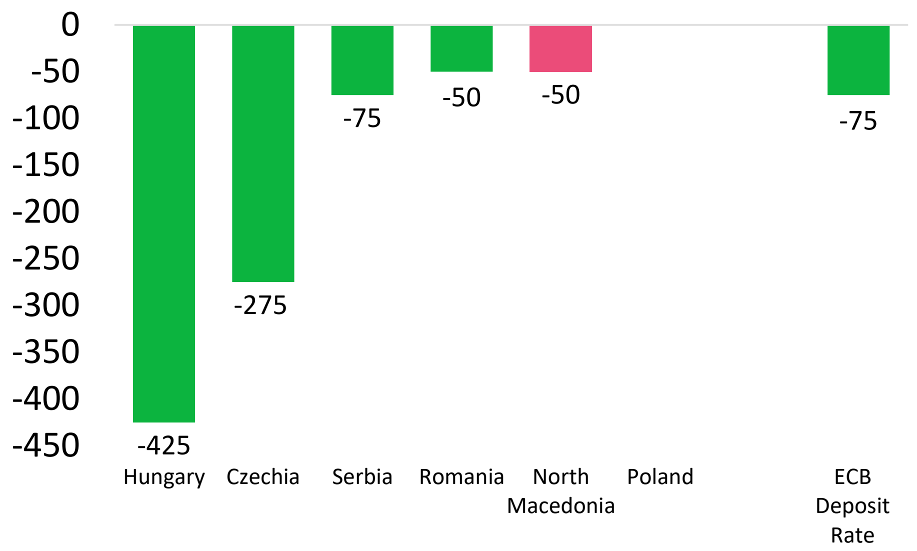
Government finalized a 15-year loan deal with Hungary worth EUR 500mn. The loan comes with a 3-year grace period and at a below market rate of 3.25%. Half of the loan should be distributed to the corporate sector (through local banks) which should mark the start of a new private investment cycle in the country. The rest of the loan could be used to meet revised budgetary needs and high planned public capex, but also as pre-financing for 2025. According to the supplementary budget, the MoF plans to carry a cash buffer of around EUR 520mn into 2025. Refinancing needs in the upcoming period are high as Eurobonds mature in each of the next four years. According to the freshly adopted fiscal strategy, to meet principal repayments alone the government will need EUR 1.2bn in each of the next three years, and EUR 1.5bn in 2028. Assuming an average budget gap of around EUR 600mn total gross refinancing needs climb close to EUR 2bn on average each year. Such high needs suggest the government will rely heavily on both domestic and external sources of financing, including the Growth Plan for the Western Balkans which could potentially bring EUR 750mn in loans and grants in the next three years. Concessional financing from the World Bank and EBRD are also expected to continue. The Precautionary and liquidity line from the IMF, established in late 2022, expires this month and there is currently no available information about a potential new setup.

Monetary and Fiscal Developments

NBRNM started cutting in September

The NBRNM has kept a tight monetary policy longer than other regional countries. The Central Bank initiated the first policy rate cut of 25bps in September, followed by another in October, setting the key rate to 5.80%. The foreign exchange market is stable, and the movements are favorable. The level of foreign reserves at the end of September equaled EUR 4.4bn, thus sufficient for maintaining the stability of the exchange rate.

NBRNM relatively cautious, notwithstanding weak growth
Key rate cuts YTD (in bps)

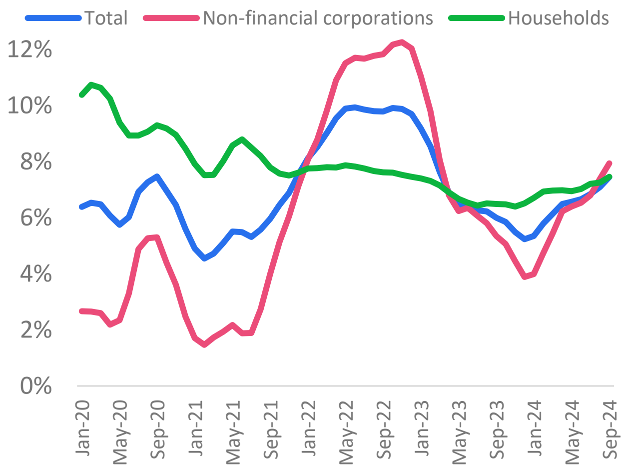


Source: Respective national central banks, Erste Group Research

Loan dynamics started accelerating

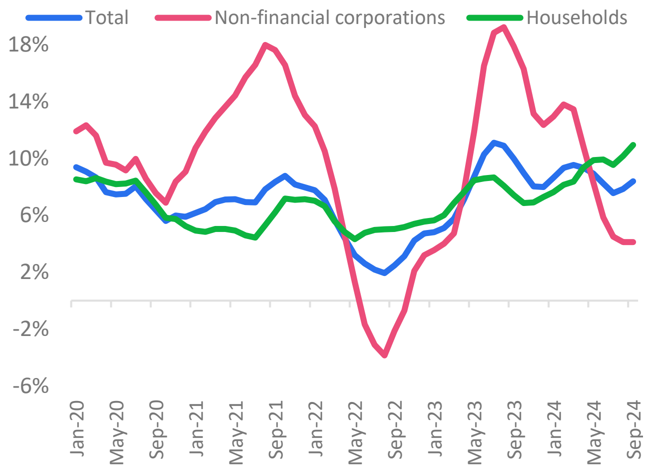
Credit activity growth amounted to 5.5% YTD in 9M24, driven by roughly similar expansion on the household and corporate side. Household credit activity rose 5.9% YTD while the expansion on the corporate side stands at 5.4% YTD. On the liabilities side, total deposits increased 4% YTD in 9M24 basically exclusively due to rising retail deposits (6.7% YTD), given flat development on the corporate side and contracting public deposits. L/D ratio has thus increased by 1pp, rising to 84.4%. The banking system remains stable, well-capitalized and showing increased profitability.

Credit activity improved in both retail and corporate
Bank loans to institutional sectors (3mma, y/y)



Source: NBRNM, Erste Group Research

Retail deposit growth curbed corporate outflows
Bank deposits by institutional sectors (3mma, y/y)



Source: NBRNM, Erste Group Research

No fiscal consolidation on the horizon

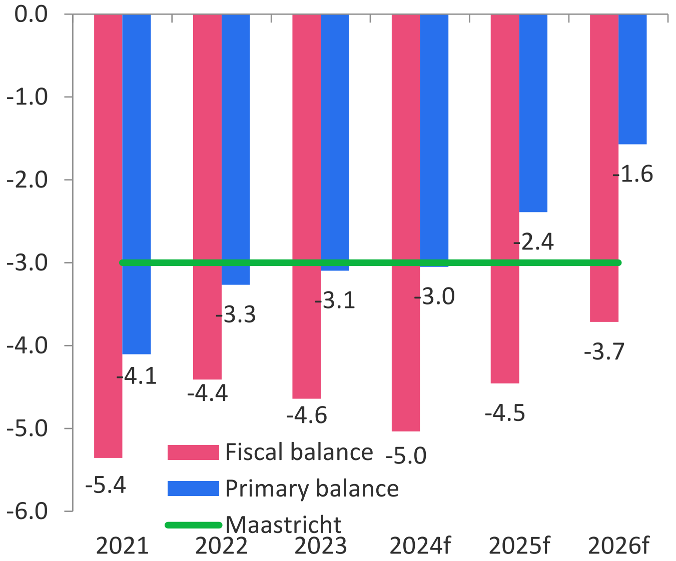
Quickly after forming the government, the new administration rebalanced the budget setting the expected budget gap to 4.9% of GDP, up from 3.4%. The move was not surprising given that already at 1H24 the deficit is 2.7% of the GDP. In our previous report we pointed out that the old target was unrealistic and had already back in May expected a gap of 4.4% of GDP. Part of the revision is due to apparent discovery of arrears incurred under the previous government while part can be explained pension and public sector wage hikes. Also, growth has been partly adjusted downwards in accordance with weak 1H24 performance. For the FY24 we expect a budget gap of 5% of GDP and only minor improvements next year (4.5% of GDP). Due to continuous, relatively high budget gaps, public debt is surging, and we expect it in the vicinity of 70% of GDP next year.

Public debt in the vicinity of 70% of the GDP

The Organic budget law, which was passed by the Parliament in September 2022 and is supposed to enter into force in its entirety as of 2025 introduces fiscal rules which set a cap on the deficit (3% of GDP) and debt (60% of GDP), and a Fiscal Council and strengthens the medium-term budget procedure. The adoption of secondary legislation to implement the law is behind schedule. Looking at the new fiscal strategy and proposed 2025 budget we don't expect the country to be compliant with the OBL until 2027 at least. That means that country continues to lack a fiscal policy anchor.

Large fiscal loosening continues

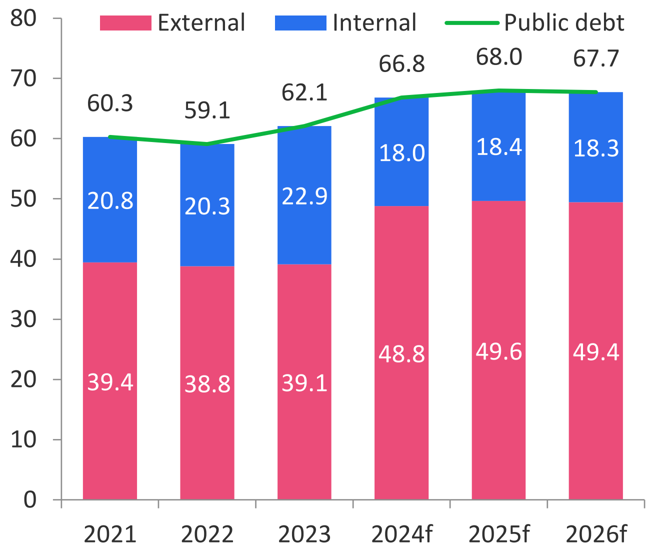
General government budget balance (in % of GDP)



Source: MoF, Erste Group Research

Public debt climbing towards 70% of GDP

Public debt (in % of GDP)



Source: MoF, Erste Group Research

Politics

Bilateral dispute with Bulgaria still blocking progress on EU path

After meeting the head of the European Council, Charles Michel, and attending a work lunch with the European Commission President, Ursula von der Leyen, in September in Brussels, North Macedonia's Prime Minister Hristijan Mickoski said he was determined to convey his people's frustration over the country's blocked EU accession path. However, the standstill on the country's EU accession path remains in place due to a bilateral dispute with EU-member Bulgaria.

But for EU accession talks to progress with North Macedonia, it has to adopt a change to its constitutional preamble and name Bulgarians among the state's founding peoples. It is a move that Mickoski's new right-wing government has hinted it has no intention of doing unless it gets more favourable conditions. When talking about possible solutions, Mickoski in Brussels did not mention his government's push for a so-called "French Proposal Plus". But, ahead of the visit, his government briefed the media that one of the goals of the trip would be to promote altering the existing so-called "French Proposal". The idea, which the government said would not be presented in written form, is to seek a delay in implementation of the "French Proposal" so that the country would vote for the constitutional change now, but it would enter into force only once the country completes EU accession talks.
Given lack of interest from the Bulgarian side for this proposal the current deadlock will likely continue for the foreseeable future.

Forecasts

Annual	2017	2018	2019	2020	2021	2022	2023f	2024f	2025f	2026f
Nominal GDP (EUR mn)	10,038	10,744	11,262	10,852	11,835	13,033	13,655	14,395	15,191	16,177
Population (mn)	1.9	1.9	1.9	1.9	1.8	1.8	1.8	1.8	1.8	1.8
GDP per capita (EUR)	5,276	5,673	5,979	5,809	6,453	7,122	7,477	7,898	8,352	8,911
Real GDP (growth y/y %)	1.1	2.9	3.9	-4.7	4.5	2.2	1.0	2.0	2.6	3.3
Private consumption (growth y/y %)	2.1	3.7	3.7	-3.8	8.8	3.8	2.4	2.2	2.5	2.7
Fixed capital formation (growth y/y %)	-2.2	1.7	9.5	-15.7	3.7	9.4	-16.7	8.6	9.2	10.0
Nominal gross wages (EUR)	548	579	609	658	696	773	892	1,014	1,138	1,256
Gross wages growth (%)	2.6	5.7	5.1	8.0	5.8	11.1	15.4	13.6	12.2	10.4
CPI (y/y, average %)	1.4	1.5	0.8	1.2	3.2	14.2	9.4	3.3	3.0	3.1
CPI (y/y, year end %)	2.4	0.9	0.4	2.3	4.9	18.7	3.6	3.4	2.7	3.5
Unemployment (%)	22.3	20.6	17.1	16.2	15.4	14.4	13.1	12.5	11.9	11.7
Trade balance (% of GDP)	-17.8	-16.2	-17.3	-16.6	-19.7	-26.7	-19.3	-21.6	-22.2	-22.7
Current account balance (% of GDP)	-0.8	0.2	-3.0	-2.9	-2.8	-6.2	0.4	-2.2	-2.8	-3.1
Net FDI inflow (% of GDP)	1.8	5.6	3.2	1.4	3.3	5.0	3.6	5.1	4.1	3.8
General government budget balance (% of GDP)	-2.8	-1.1	-2.1	-8.2	-5.4	-4.4	-4.6	-5.0	-4.5	-3.7
Public debt (% of GDP)	47.7	48.4	49.2	59.7	60.3	59.1	62.1	66.8	68.0	67.7
Foreign debt to GDP (%)	73.4	73.0	72.4	78.7	80.9	82.8	83.9	84.8	84.3	84.1
Bond yield (EUR 2028) average					2.0	5.5	6.4	5.2	4.7	4.1
Bond yield (EUR 2028) year-end					2.7	6.7	5.2	5.0	4.2	3.6
EUR/MKD	61.6	61.5	61.5	61.7	61.6	61.6	61.6	61.6	61.6	61.6

Note:

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

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