

**EXECUTIVE
BOARD
MEETING**

EBS/20/37
Correction 1

April 10, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of North Macedonia—Request for Purchase Under the Rapid Financing Instrument**

Board Action:

The attached corrections to EBS/20/37 (4/6/20) have been provided by the staff:

Evident Ambiguity

Page 4

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Pages 3 and 5

Typographical Errors

Page 2

Questions:

Ms. Barkbu, EUR (ext. 38138)
Mr. Poulain, EUR (ext. 39444)
Mr. Mangov, EUR (ext. 36583)

Approved By
Jörg Decressin (EUR)
 and
Vikram Haksar (SPR)

Discussions were held by teleconference during March 26–30, 2020. The mission discussed with Finance Minister Angelovska, Governor Angelovska Bezhoska, and other senior officials.

The staff team comprised Ms. Barkbu (head), Messrs. Poulain and Mangov (all EUR), Ms. Eble (Resident Representative), and Mr. Nacevski (IMF Local Economist). Mr. Doornbosch and Ms. Harutyunyan (OED) attended some of the meetings. Ms. Maneely and Ms. Tenali (EUR) assisted in the preparation of the report.

CONTENTS

RECENT DEVELOPMENTS	3
IMPACT OF COVID-19	3
ECONOMIC POLICIES	4
MODALITIES OF FUND FINANCIAL SUPPORT	5
RISKS	7
STAFF APPRAISAL	7
BOX	
1. Debt Sustainability Assessment	9
FIGURE	
1. Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario	10
TABLES	
1. Summary of Economic Indicators, 2016–25	11
2a. Central Government Operations, 2016–25 (Billions of denars, unless otherwise indicated)	12
2b. Central Government Operations, 2016–25 (Percent of GDP, unless otherwise indicated)	13
3a. Balance of Payments, 2016–25 (Millions of euros, unless otherwise indicated)	14
3b. Balance of Payments, 2016–25 (Percent of GDP, unless otherwise indicated)	15
4. Monetary Survey, 2016–25	16
5. Central Bank Survey, 2016–25	17
6. External Financing Requirements, 2020–25	18
7. Indicators of Capacity to Repay the Fund, 2020–25	19
8. Financial Soundness Indicators of the Banking System, 2012–19	20
APPENDIX	
I. Letter of Intent	21

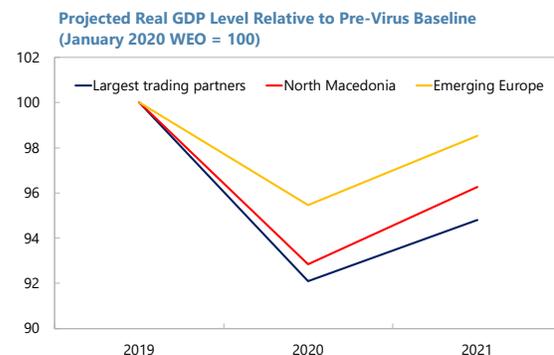
RECENT DEVELOPMENTS

1. Before the pandemic, the macroeconomic performance was favorable. Growth was solid and broad-based at 3.6 percent in 2019 and was expected to soften to 3.4 percent in 2020. The fiscal deficit reached 2 percent of GDP in 2019, keeping public debt stable at ~~47~~ 48 percent of GDP, and was projected to widen to 2½ percent of GDP in 2020 mainly due to higher pension benefits and a public sector wage hike. The external position was broadly in line with fundamentals, and reserve coverage reached 114 percent of the Fund's Assessing Reserve Adequacy (ARA) metric in 2019. The banking system was well capitalized and liquid, and non-performing loans relatively low, but efforts were needed to mitigate the indirect credit risks from the high share of FX lending, the widespread use of adjustable-rate loans, and high lending concentrations. Over the past years, crucial governance and institutional reform have demonstrated the authorities' commitment to tackling long-standing challenges. As a result, in March, the EU finally agreed to start accession negotiations with North Macedonia, a major milestone.

IMPACT OF COVID-19

2. The rapid spread of COVID-19 is taking a major toll on the economy. North Macedonia has 555 confirmed cases of COVID-19, and has declared a state of emergency, closed its borders and imposed severe social-distancing restrictions to slow down the spread of the virus. While necessary, these containment measures are expected to curtail domestic economic activity. The downturn will be amplified by spillovers from the global recession. Financial market turbulence, combined with the postponement of the political elections, has made the prospects of the authorities' plan to issue a €500 million Eurobond in the summer more uncertain. At the same time, the government's financing need has increased.

3. Staff project real GDP to contract by 4 percent in 2020, a reduction by 7½ percentage points relative to the Article IV report published in January 2020. Private consumption is expected to fall as disposable income comes under pressure amid rising unemployment and as spending on travel, hospitality and entertainment is slashed due to regulatory restrictions. Private investment should also experience negative growth, as plans are delayed toward the end of the year, and exports are projected to decline, as the European automotive industry stops production. While in the baseline growth resumes in the second half of 2020, the output level will recover only slowly, and not converge to the pre-virus baseline even over the medium term.



Source: IMF WEO.

Note: Trading partners weighted by their share in North Macedonia's exports.

4. The fiscal position is expected to deteriorate. The containment measures will sharply reduce firms' profits, employment, and consumption, creating sizeable revenue shortfalls relative to

budgeted amounts. At the same time, spending on health, as well as unemployment and social benefits, is likely to be higher than budgeted. In addition, the authorities have taken measures to support economic activity. As a result, staff expect the general government deficit to increase to 6½ percent of GDP in 2020 before receding to about 3 percent in 2021.

5. Absent additional external financing, reserve coverage would fall as remittances and FDI inflows drop. Remittances and FX cash exchanges are expected to fall as migrants' income abroad shrink. With investment plans likely to be delayed, net FDI inflows are also projected to contract/decline. As a result, reserve coverage is expected to/would decrease to 87 percent of the ARA metric by end-2020, absent IMF and other external financing such as the potential Eurobond issuance.

6. In this context, the authorities have requested a purchase under the Rapid Financing Instrument (RFI) to address the urgent fiscal and balance of payments needs, see the attached Letter of Intent (LOI). The purchase will help provide the government with much needed liquidity, while helping to preserve international reserves, thus protecting the de-facto exchange rate peg.

ECONOMIC POLICIES

7. The authorities are taking actions to mitigate the economic impact, as outlined in their attached Letter. The government implemented in March a 0.2 percent of GDP package of targeted and temporary fiscal measures to provide cash-flow relief to affected firms and protect jobs (LOI ¶2). The National Bank of the Republic of North Macedonia (NBRNM) cut its policy rate, amid lower-than-expected inflation. The NBRNM has also taken steps to encourage banks to restructure loans to affected borrowers, subject to closer monitoring on a case-by-case basis (LOI ¶3). The NBRNM has lengthened the limit for classifying loans as NPLs from 90 to 150 days. While temporary, with the limit to return to 90 days by end-2020, staff consider that such a weakening of loan classification standards can hamper the proper assessment of credit risk, and encouraged the authorities to closely monitor developments and avoid any further relaxation of loan classification or provisioning standards.

8. In the near term, the focus should be on limiting the macro-financial and social impact of the crisis, while maintaining a sound policy framework to support the recovery.

- **Fiscal policy support should be well-targeted and temporary.** In this vein, the authorities have announced an additional package of measures, including a wage subsidy to protect employment in the private sector (about 1 percent of GDP) and transfers to poor households during the second quarter of 2020 (LOI ¶2). To help offset the costs, they will defer capital expenditure, and implement temporary cuts to the public sector wage bill and purchase of goods and services. Given the country's large infrastructure needs, cuts to capital expenditure should be temporary. Bolstering the capacity of the health care system to address the COVID-19 shock should remain a priority.
- **The NBRNM needs to balance the need to support the economy through providing liquidity, with the objective of protecting the exchange rate peg.** Inflation remains low, at

0.7 percent year-on-year in February, and is expected to move into negative territory in the next months. The NBRNM has intervened in the past month to stabilize the exchange rate and should stand ready to take action as necessary to protect the peg.

- **Preserving financial stability remains a priority.** Over the past years, banks have strengthened their liquidity and capital positions, with the banking system's capital adequacy ratio at 16.3 percent at end-2019. These buffers now provide an important line of defense against potential losses. To facilitate prudent restructuring and support banks' ability to finance the economy during the downturn, staff encourages the NBRNM to explore further steps that make use of the flexibility in the regulatory framework, such as permitting banks to draw down the capital conservation buffer that is designed to be used in periods of stress. This would require careful capital and liquidity planning by banks, together with enhanced monitoring and reporting by the NBRNM. ~~The NBRNM should clarify that~~ Freed-up resources ~~cannot~~ could not be used to distribute dividends, pay out cash bonuses or initiate share buybacks. The NBRNM should continue to monitor banks' liquidity intensively and stand ready to act as needed to address any stress.

MODALITIES OF FUND FINANCIAL SUPPORT

9. **The pandemic has created an urgent balance of payments need** (LOI ¶3). The downturn has increased the general government deficit. Some of the government's net financing need can be covered through domestic and external banks, and by drawing down government deposits at the central bank. Moreover, the EU and the World Bank are expected to contribute with at least €95 million in budget support and for measures to alleviate the social and economic impact of the pandemic, though discussions are at an early stage. On this basis, staff project a remaining fiscal and external gap of about €213 million, after Fund financial assistance (Text Table 1 and Table 6). The RFI purchase would help keep reserve coverage at 93 percent of the ARA metric at end-2020 (Text Table 2). A potential Eurobond issuance would help close this gap.

Text Table 1. Fiscal and External Financing, 2020–21 (€ million)

	2020	2021
Total Financing Requirement (Gross)	1,969	1,923
Central Government Deficit	727	371
Gross Amortizations	1,242	1,552
Domestic	803	821
External	439	732
Private	360	644
Official	79	88
Total Financing Sources (Gross)	1,485	1,923
Government deposits at the NBRNM (budget account)	100	-20
Flow from Denar budget account	45	-9
Flow from FX budget account	55	-11
Domestic	1,178	1,239
External	207	704
Private	120	555
Official	87	149
Fiscal and External Gap	484	0
IMF – RFI	177	0
European Union/World Bank	95	0
Remaining unidentified financing	213	0