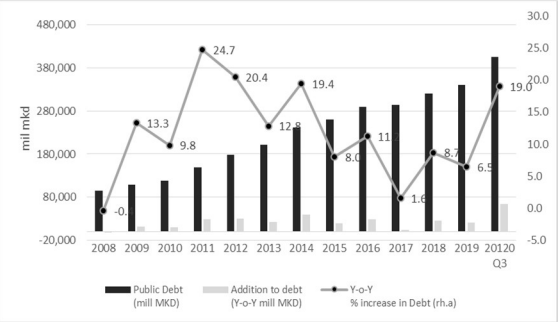
Policy Brief:
The Galloping Public Debt of Macedonia. Can we hope for sustainability?

- *Public debt is on an unsustainable path, with annual deficits adding to the debt at a pace exceeding the rate of economic growth*
- *The public debt stabilizing primary balance is projected at negative 0.5%*
- *The fiscal policies are continuing towards the increasing public debt-to-GDP ratio in the midterm plans without significant government policies for consolidation*
- *The indicative threshold of public debt-to-GDP over 50% is way passes and topped over*

Galloping Macedonian public debt

Erosion of fiscal transparency and discretionary policies can lead to unexpected increases in debt, with adverse financial and economic consequences, as was the case of RNM context in the past decade; The 2020 Covid-19 pandemic caused additional strain on the public debt caused by the need for financing the negative shock impact, coupled with the packages for economic relief and aid.

Thus the public debt sustainability comes to an increasing interest again since the public debt more than tripled in the period between 2009 and 2019, and in the three quarters of 2020 increased with additional 64,745 mil MKD (total public debt Q3 2020, 405.4 billion MKD[1]) reaching the relative value of ~61% of the GDP i.e. ***with additional 11 pp of the GDP.***

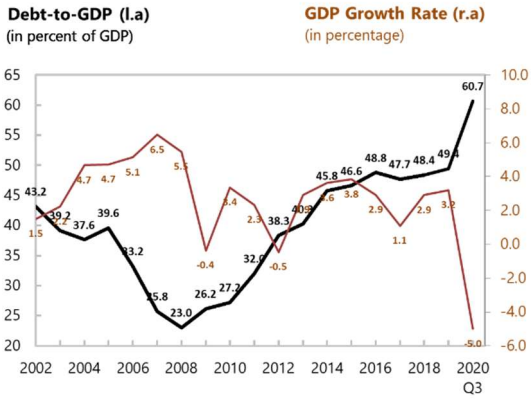


Source: Based on MoF data

Tax revenues over public debt decreases significantly, and the remaining debt burden ratios deteriorate as well. Despite concerns over the rising public debt load, the government's intent is pursuing on new debt instruments generating additional debt was further increased with additional need for financing due to the drop of revenues and increase of expenses triggered by the pandemic.

The fiscal rule proposed as a constitutional change in 2014 as an initiative to the Parliament for a fiscal rule of 60% of the GDP, and of budget deficit of 3%, ended with no amendments in the Constitution. Furthermore the new proposed draft of organic budget law, again does not clearly stipulate fiscal rules concerning the public debt.

Figure 1 Debt-to-GDP and Real Growth rate trends in Macedonia



Source: Based on MoF data

As of 2019 the amendments to the public debt law that enacted changes towards inclusion of the non-guaranteed debt in the scope of the public debt; net expression of the debt; "pulling-out" a strategy for public debt management as a stand-alone strategy away from the Fiscal Strategy where the maximum amount of net debt for the first year of the mid-term

[1] 6.57 billion EUR

strategy will be set, was not implemented yet, likely due to the pandemics, and neither an annual report was prepared.

This situation calls for new efforts to contain vulnerabilities rising from increasing levels of public debt although taking on debt is one of the ways in which countries can finance the needed investments in infrastructure, human capital or public works. However, good debt management is critical for these investments to be successful.

Table 1 Evolution of debt burden indicators

DEBT BURDEN RATIOS	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	P2020*
Total public debt-to-GDP	0.27	0.32	0.38	0.40	0.46	0.47	0.48	0.47	0.48	0.49	0.61
Total public debt-to-Revenue	0.90	1.08	1.30	1.44	1.65	1.62	1.71	1.64	1.70	1.67	2.07
Debt service-to-GDP	0.02	0.02	0.02	0.04	0.03	0.06	0.05	0.04	0.05	0.04	0.09
Debt service-to-Revenue	0.08	0.08	0.07	0.14	0.10	0.22	0.16	0.14	0.19	0.12	0.31
Gross financing needs-to-GDP	0.04	0.04	0.05	0.07	0.06	0.09	0.06	0.06	0.06	0.04	0.16
Gross financing needs-to-revenue	0.14	0.14	0.17	0.25	0.22	0.30	0.22	0.19	0.21	0.15	0.55
Total Net Public Debt-to-GDP	0.27	0.32	0.38	0.40	0.46	0.47	0.48	0.47	0.48	0.49	0.61
Total Net Public Debt-to-Revenue	0.90	1.08	1.30	1.44	1.65	1.62	1.71	1.64	1.70	1.67	2.07
Total Gross Public Debt-to-potential GDP	0.19	0.23	0.28	0.30	0.35	0.36	0.39	0.39	0.40	0.43	0.53

*Note: *2020* Projection, Source*: Authors calculations, based on data of MoF

Debt Sustainability Analysis Scenarios and Results

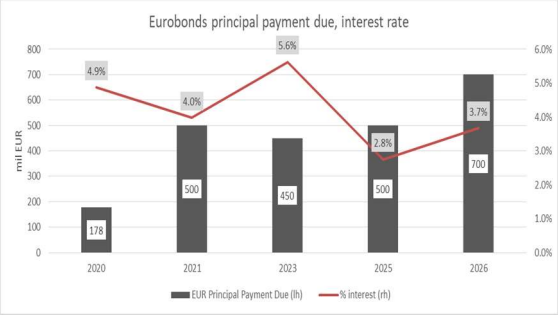
IMF (2010) suggests that Macedonia should take into account a prudent level of 25% of public debt over GDP (following also an IMF Vulnerability study from 2007), as there is no consensus among researchers and academicians on what would be the appropriate public debt target for emerging markets. IMF suggests a generally-accepted conclusion that emerging markets can sustain lower levels of debt than advanced economies[2]. This clearly states that the rule of law, quality of institutions is directly linked to the sustainable level of public debt in a specific country

North Macedonia as a candidate country with ambition to join EU should not think to take into account the 60% debt-to-GDP Maastricht criteria as a prudent level, however was breached recently.
A proper assessment of fiscal policy and public debt trajectory must be based on certain macroeconomic baseline assumptions, notably economic growth and the interest rate on public debt, as well as the likelihood that fiscal risks might materialize[3]. It is widely considered that the Macedonian public debt-to-GDP is on an unsustainable path and there is a need for a proper monitoring tool that will not only trivially follow-up the debt-to-GDP ratio but also, the gross financial needs, and the "quality" of the public debt generated.

Under a ***baseline scenario*** of the debt sustainability analysis using the IMF's DSA tool indicates that the rapid rise in public debt has largely depleted the fiscal space which can be considered as unsustainable ***especially due to increasing financing need in the medium run, faced with the need to service the external debt*** of the existing Eurobonds (maturing debt in 2020, 2021, 2023, 2025 and 2026).

[2] Because economic and institutional features limit both the feasibility and the credibility of these countries' debt-servicing abilities (Reinhart, Rogoff and Savastano (2003), IMF (2002)).

[3] Modernizing the Framework for Fiscal Policy and Public Debt Sustainability, IMF, 2011



Source: Based on MoF data

In projection of a conservative economic growth, while following the DSA model (anticipating negative -5% growth scenario for 2020, and 4% real economic growth rate in 2021 and 2022, up to 3.5% from 2023 to 2025), under the IMF's DSA risk based approach for a low/high scrutiny country, the debt is expected to keep and exceed the both the 60% of the GDP and the 10% of gross financing needs (GFN) to GDP thresholds. The benchmarks of emerging markets (EM) is PD of 50% of GDP and 10% of GFN.

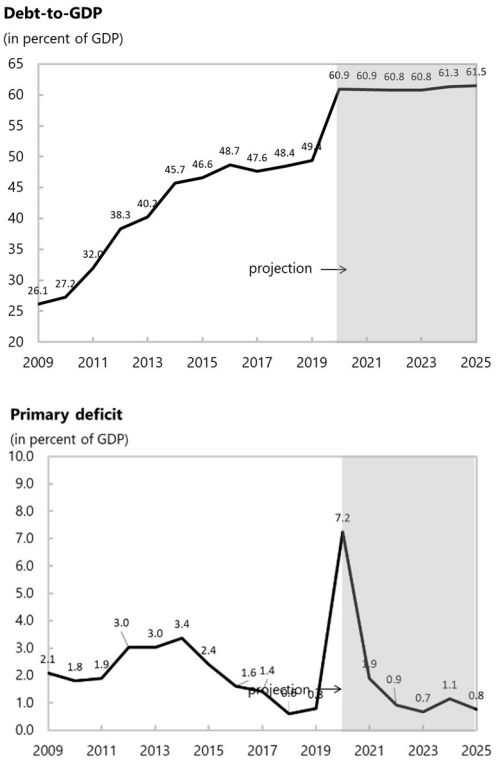
At this point the benchmarks threshold has been reached and surpassed, while not expected not to drop in a mid-run period:

		2019	2020	2021	2022	2023	2024	2025	
Public Gross Debt >	50 percent of GDP?	49.4	60.9	60.9	60.8	60.8	61.3	61.5	Yes
Public Gross Financing Ne	10 percent of GDP?	4.3	16.3	13.5	9.4	13.7	12.5	16.6	Yes

Under the baseline scenario by using the IMF MAC DSA model the public debt of Macedonia is expected to increase close to 61.5% of the GDP in the following period to 2025. The baseline scenario is based on the current projected government policies with considering Q3 2020 debt level as the final debt for 2020[4], other 2020 data are based on the supplementary budget[5].

The public debt dynamics shows increase of debt-to-GDP change rate in the following five years[6] with an increasing trend. Overall in the period considered we project a change of increased debt-to-GDP of positive 1 p.p.

Figure 2 Debt-to-GDP and primary deficit to GDP trend



Source: Based on data from MoF and projections of author

North Macedonia is running and continue to run a primary deficit throughout the period as it is main contributor to the increased public debt, especially increasing in 2020. The current explosive level of the primary balance as well as the projected primary balance will not stabilize the debt-to-GDP ratio and further fiscal adjustment are required to bring the primary balance to a level that is necessary to service public debt and even towards debt reduction.

Within the baseline scenario a decomposing of the public debt changes to basic measurable debt-crating flows, provides input on the variables which have significant impact on the movements of public debt and what to expect in the future under the provided assumptions which are in essence comparable with the assumptions of the policy makers.

[4] The final debt for 2020 might be higher when the updated data is to be published

[5] The projection for the following Y+2 public expenditure is based on the last available revised fiscal strategy projections

[6] the projection period is set to current plus five years as to increasing uncertainty on a longer run under the assumptions

Figure 3 Debt Economic and Market Indicators

Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2009-2017 [2/]	2018	2019	2020	2021	2022	2023	2024	2025
Nominal gross public debt	39.2	48.4	49.4	60.9	60.9	60.8	60.8	61.3	61.5
Public gross financing needs	5.7	6.0	4.3	16.3	13.5	9.4	13.7	12.5	16.6
Net public debt	39.2	48.4	49.4	60.9	60.9	60.8	60.8	61.3	61.5
Public debt (in percent of potential GDP)	29.8	40.4	43.0	53.4	50.5	51.3	51.4	52.2	52.7
Real GDP growth (in percent)	2.1	2.7	3.6	-5.0	4.0	4.0	3.5	3.5	3.5
Inflation (GDP deflator, in percent)	2.4	3.6	2.4	1.8	1.0	1.3	1.3	1.3	1.3
Nominal GDP growth (in percent)	4.6	6.9	4.3	-3.4	6.4	5.4	4.8	4.8	4.8
Effective interest rate (in percent) [4/]	2.7	2.6	2.5	2.6	3.2	3.7	3.8	4.0	3.9

As of may 15, 2020		
Sovereign Spreads		
Bond Spread (bp) 3/		289
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	n.a.	n.a.
S&Ps	BB-	BB-
Fitch	B	BB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2009-2017	2018	2019	2020	2021	2022	2023	2024	2025	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.7	0.8	1.0	11.5	-0.1	-0.1	0.0	0.6	0.2	12.1	
Identified debt-creating flows	2.9	-5.7	1.0	10.3	0.8	-0.1	0.1	0.7	0.3	12.0	
Primary deficit	2.3	0.6	0.8	7.2	1.9	0.9	0.7	1.1	0.8	12.6	-0.5
Primary (noninterest) revenue and grants	29.0	28.5	29.6	29.5	30.4	30.7	31.1	30.5	30.8	182.9	
Primary (noninterest) expenditure	31.3	29.1	30.4	36.7	32.3	31.6	31.8	31.6	31.6	195.5	
Automatic debt dynamics [5/]	0.6	-6.3	0.2	3.0	-1.1	-1.0	-0.6	-0.5	-0.5	-0.6	
Interest rate/growth differential [6/]	-0.7	-1.7	-1.6	3.0	-1.1	-1.0	-0.6	-0.5	-0.5	-0.6	
Of which: real interest rate	0.1	-0.5	0.0	0.5	1.2	1.3	1.4	1.6	1.5	7.6	
Of which: real GDP growth	-0.8	-1.2	-1.6	2.6	-2.3	-2.3	-2.0	-2.0	-2.0	-8.2	
Exchange rate depreciation [7/]	1.3	-4.5	1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (1) (e.g., privatization receipts) (+ reduces financing needs)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., other debt flows) (+ increases financing needs)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-0.2	6.5	0.0	1.3	-0.9	-0.1	-0.1	-0.1	-0.1	0.1	

Source: Based on data from MoF and projections of author, used within the IMF's DSA model

The main contributor to the debt is the primary budget deficit and is expected to be the main contribution in the following period as well. On a cumulative basis within the projected period its contribution in the change on the public debt is 12.6p.p of GDP. The overall GDP growth as projected with moderate rate after 2020 is contributing to bringing down the debt of – 8.2 p.p. in the projected period on a cumulative basis.

The real interest rate is also a variable that needs to be closely monitored and in the medium run is expected to contribute to increased debt in the following period on a cumulative basis of 7.6p.p.

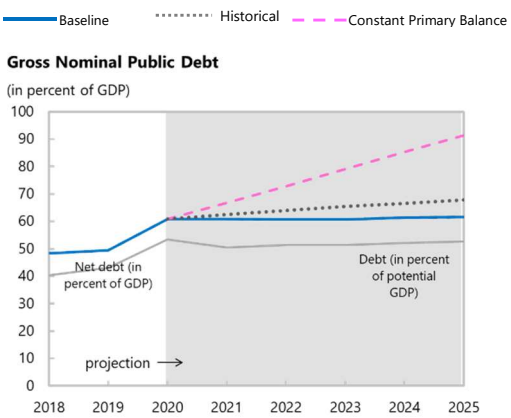
The debt stabilizing primary balance is reaching negative 0.5% of GDP for 2025.The public debt stabilizing primary balance for 2020 is calculated at 3% of GDP, and moving to negative 1.1% in 2021. This indicates that to reach stabile debt-to-GDP ratio the primary balance deficit should be set at an average 0.5% of GDP in the period considered. It should be noted that debt dynamics is particularly sensitive to the interest and economic growth rate assumptions, thus a slide in the projected economic real growth rate or change in the real interest rate may significantly affect the public debt dynamics and the debt stabilizing primary balance.

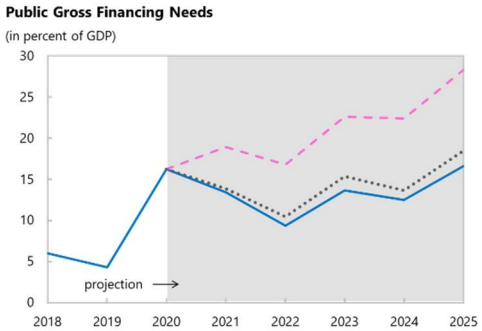
The heat map identifies the additional vulnerabilities on the public debt level, gross financing needs and debt profile. Under the baseline scenario the gross financing needs are most prone to vulnerabilities, from GDP growth shocks, to the debt composition from external public debt and held by non-residents.

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Under the alternative *Historical scenario*, considering the average historical data it is projected that the public debt-to-GDP is increasing higher compared to the baseline scenario. The historical scenario assumes lower annual real growth of 2.6% (after 2020), based on the average real economic growth in the past decade, and at the same time higher primary deficit also set at the ten year average of 2.0%.





Alternative Scenarios

Underlying Assumptions

(in percent)

Historical Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	-5.0	2.6	2.6	2.6	2.6	2.6
Inflation	1.8	1.0	1.3	1.3	1.3	1.3
Primary Balance	-7.2	-2.0	-2.0	-2.0	-2.0	-2.0
Effective interest rate	2.6	3.2	3.2	3.1	2.9	2.7
Baseline Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	-5.0	4.0	4.0	3.5	3.5	3.5
Inflation	1.8	1.0	1.3	1.3	1.3	1.3
Primary Balance	-7.2	-1.9	-0.9	-0.7	-1.1	-0.8
Effective interest rate	2.6	3.2	3.7	3.8	4.0	3.9
Constant Primary Balance Scenario						
Real GDP growth	-5.0	4.0	4.0	3.5	3.5	3.5
Inflation	1.8	1.0	1.3	1.3	1.3	1.3
Primary Balance	-7.2	-7.2	-7.2	-7.2	-7.2	-7.2
Effective interest rate	2.6	3.2	3.6	3.7	3.8	3.7

Considering the lower growth, and higher primary deficit, the resulting situation is higher gross financial needs that are significantly increasing under the historical scenario in compassion with the baseline scenario projections.

Under the alternative *Constant primary balance scenario*, the primary balance is set at -7.2% of the GDP throughout the period without changes to the other variables. In this setting, the debt-to-GDP is explosive and not likely to realize.

Conclusions

- Public debt of RNM according to the last data for Q3 2020 is 6,571 mill EUR or 60.7% of GDP (GDP projection of MoF).
- RNM is in the category of countries with market access and according to the IMF these countries (it is advisable) not to cross the 50% debt to GDP ratio and 10% gross financing needs of the GDP. The current state indicates that we have already surpassed these limits.
- Our assessment indicates that the public debt is not on a sustainable track.
- The determinants driving the public debt of RNM are predominantly the primary deficit and the gross financing needs. The latter is expected to keep the "high" value due to the need for financing the maturing Eurobond principle debt due in 2020, 2021…
- The primary deficit as a main contributor to the debt and without drastic reduction will continue to be the driver of the debt. It is expected to stabilize in the mid run and drop in the next years. It is essential for the primary balance plans to be obeyed and contain the deficit.
- The debt stabilizing primary balance under the baseline scenario in the projected period, reaching negative 0.5% of GDP for 2025. This indicates that in order to reach stabile debt-to-GDP ratio the primary balance deficit should be set at 0.5% of the GDP.
- Debt dynamics is particularly sensitive to the interest and growth rate assumptions, thus a slide in the projected growth rate or change in the real interest rate may significantly affect the debt dynamics and the debt stabilizing primary balance.

Update of the debt sustainability path for RNM November 2020

Further details of past reports on the subject are available at: https://cea.org.mk/politichka-ekonomija-na-javniot-dolg-odrzhlivost-na-javniot-dolg-sluchajot-na-makedonija/