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Serbia **January 2018**	Kalina Dimitrova, Lead Economic Analyst **k.dimitrova@bcra-bg.com**
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SOVEREIGN RATING	Initial rating	Review
Date of Rating Committee	**31.07.2017**	**24.01.2018**
Date of rating publication	**11.08.2017**	**26.01.2018**
Long-term rating	**BB- (ns)**	**BB (ns)**
Outlook	**Stable**	**Stable**
Short-term rating	**B (ns)**	**B (ns)**

● (ns) – not solicited rating

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"BCRA - CREDIT RATING AGENCY" AD rates Serbia with unsolicited sovereign long-term rating BB (ns) and short-term B (ns) with stable 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 Statistical Office of the Republic of Serbia, the National Bank of Serbia, 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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There are no significant changes concerning political environment in Serbia over the second half of 2017. The Serbian Progressive Party (SNS) continues to dominate the political situation in 2017 as its leader, Aleksandar Vučić, was elected for president in April and the latter has the political support of the new government headed by Ana Brnabić, who replaced Vučić as prime minister of the state.

Serbia is a candidate for European Union membership and could benefit from continued institutional improvements as part of the EU accession process. Official negotiations on Serbia's accession were opened in early 2014, and they are currently in process. In December 2017, two more chapters were opened concerning corporate law (Chapter № 6) and international relations (Chapter № 30). They both are of key importance for the future economic development and overall stability so Serbia.

Dispute about Serbia-Kosovo relations has been reconfirmed as a major issue in the EU accession process of Serbia. Relations between Serbia and Kosovo have been tense since 2008, but in 2013 both countries agreed to participate in the EU-sponsored negotiations on normalizing relations, a condition for both countries to progress on their way towards membership in the bloc. A broad debate on relations with Kosovo has recently been initiated in Serbia by the President.

Following the real GDP growth of 2.8% in 2016, positive economic trends are continued during 2017, although at somewhat slower pace. The year-on-year GDP marks growth of 1.6% in the first nine months of the year. On the demand side, economic performance of the country is mainly driven by the domestic demand. Growth of employment and salaries, lower cost of financing as well as favourable price trends, have all boosted spending, which results in an increase in final consumption. Investment activity in the first half of the year was subdued, undermined by delays in government capital spending. However, this trend seems to be overcome during the third quarter. Net exports have negative impact on the GDP growth in 2017.

Growth in gross value added during 2017 is affected by adverse weather conditions which hit the agriculture sector in the first half of the year Construction sector also shows volatilities in its development, while services and industry remain robust.

Serbia's major trading partners are EU member states, which account for 66.4% of total exports and 62.5% of total imports. The progress in the approximation of the county to the European Union is accompanied by lowering of barriers to trade in goods, and currently the trade in goods with the European Union is customs-free for most of the products. The shares of the leading partners (Italy and Germany) slightly narrow compared to the previous year while those of the SEE countries (Romania, Croatia, Hungary) are confirmed. As a member of CEFTA, 1/5 of Serbian exports are absorbed by other CEFTA-member countries, mainly Bosnia and Herzegovina and Montenegro. Other countries with considerable presence in Serbian foreign trade relations are Russia and also China, as the third major importer in the economy.

The overall movement in the trade of goods indicates a positive dynamics in nominal terms for both exports and imports of goods, with the majority of SITC groups backing it with positive growth rates. High value-added products - Machinery and transport equipment and Manufactured goods classified chiefly by material, preserve their prevalent weights in exports and in imports.

In 2016, current account deficit narrowed to its lowest level – 3.1% of the GDP. Balance of payments trends in 2017 are characterized by an increase in imports at a faster rate than the corresponding increase in exports, which resulted in widening of the current account deficit in the first ten months to a level that is by 70% higher than in the same period of the previous year. However, current account deficit is still being fully covered by FDI.

Net FDI flows reached 5.5% of GDP in 2016, the highest level since 2012. Trends in the first ten months of 2017 show further improvement in the investment environment as net FDI flows mark 26.4% increase compared to the same prior-year period. FDI inflows are well diversified in term of origin and focused in export-oriented industries. Favourable perception of foreign investors regarding long-term investment in Serbia is also confirmed by Serbia's advance in the World Bank's Doing Business Report.

Gross external debt of Serbia continues to shrink reaching EUR 26 033 mln (70.7% of the projected GDP) at the end of September 2017. Medium and long-term debt at original and remaining maturity accounts for 97.2% and 88.5% respectively. Given

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the favourable maturity structure, the refinancing risk is relatively low.

At the end of September 2017, official foreign reserves stand at EUR 10 636 mln. The level of reserves ensures 5.9 months coverage over imports of goods and services and 257.5% coverage of short-term external debt, enough adequate to reduces the risk of inability to respond to unexpected events occurring on international markets.

The depreciation trend of the dinar was interrupted in May 2017, as the national currency started gradually to appreciate. In November, the dinar reached its highest value against the euro in three years (since September 2014).

Labour market indicates improved performance in accordance with the real sector developments. The continued rise in employment and the reduction in unemployment in 2017 are supported by concurrent increase in the activity rate. The unemployment rate, however, remains at alarmingly high levels, much higher than representative EU-members, thus implying the presence of serious problems and obstacles standing before the economy that would take time before unemployment can reach publically comfortable levels.

GDP per capita of Serbia is much lower than the EU-average and also below the measure in neighbouring states like Romania and Bulgaria, which hold the last two places among the EU-members by this indicator. Measured by purchasing power parity, GDP per capita for the country in 2016 is almost 3 times lower than the EU-average.

Inflation, measured by CPI change, accelerates to 3.2% annual average in 2017. Annual inflation in December 2017 reaches the NBS' target midpoint of 3%. Inflation rate is likely to decelerate in the first half of 2018, due to the higher price base of petroleum products and other products which recorded one-off hikes in early 2017. In addition, the slowdown in inflation will also be affected by the strengthening of dinar. However, inflationary pressure in the period ahead will arise from the gradual increase in domestic demand and the rising inflation in the EU.

General government deficit decreased from 3.7% of GDP in 2015 to 1.3% of GDP at the end of 2016, which is the lowest level in the past ten years and much below the quantitative criterion of 2.1% of GDP, set under the sixth review of the stand-by arrangement with the IMF. The fiscal deficit narrowed mainly on account of an increase in tax revenue reflecting to a large extent the positive macroeconomic developments and accelerated economic growth.

The successful implementation of the fiscal consolidation program under the IMF arrangement is continued in 2017. Fiscal trends show a significantly stronger increase of public revenues and a somewhat smaller execution of public expenditures compared to the 2017 Budget plan, thus the MoF expects budget surplus at the end of the year in the amount of 0.7% of GDP, much better than the initially planned deficit in the amount of 1.7% of GDP

The main goals of the budget for 2018 focus on maintaining the level of macroeconomic stability achieved so far. Expressed as a share of GDP, the planned deficit of the Republic amounts to about 0.6% of GDP while General government deficit is planned at 0.7% of GDP. The budget plan foresees bonuses for employees in the security sector, such as intelligence, police and army officers, as well as the increase of salaries for employees in public sector and administration between 5 and 10 percent and increase of pensions by 5 percent. The budget also plans an increase by RSD 35 bln in capital expenditures of the central government in 2018. The medium-term fiscal framework estimates general government deficit lowering to 0.5% of GDP by 2020.

Public debt is on a firm downward path and strong fiscal consolidation measures reduce debt sustainability risks. As a share of GDP, general government public debt decreases from 73.0% at the end of 2016 to 63.5% in November 2017. Since the majority of Serbian public debt is in dollars and euros, the appreciation of dinar compared to these currencies brought about a significant decrease of the share of public debt in GDP, which is achieved in dinars. However, the large amount of debt denominated in foreign currency carries risk due to possible changes in the exchange rates for the dinar – euro and euro - US dollar. The interest rate risk is low, given the small share of debt contracted at floating rates.

The costs of government borrowing mark a falling trend since end-2012, triggered by the global developments in terms of policy relaxation. The drop is also backed by domestic factors - the successful application of fiscal consolidation measures, relatively stable exchange rate and low inflation. During 2017, weighted average interest

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rates on dinar and euro denominated securities decline further to historical minimum.

The banking sector demonstrates a generally positive development. The basic bank aggregates (assets, deposits, credits) remain nominally on the rise albeit at a slower pace compared to the nine months of 2016, thus supporting the maintenance of high system's levels of liquidity and capital adequacy. Their structure and specific trends, however, do not alter as a result of the ongoing transformations across institutions of the sector. The euro currency remains the preferred one holding over 60% in deposits and in credits of the households and non-financial corporations taking advantage of the low-interests European environment.

The quality of assets has been recognised as one of the main challenges that Serbian banking system faces as the non-performing loans (NPL) ratio varies around 1/5 of the gross loans' value during the past five years (2012-2016). The dissatisfactory high portion of NPLs in credit portfolios triggered taking actions at national level to tackle the problem such as the implementation of a *NPL Resolution Strategy* (2015) and the respective action plans. The following positive results have become visible through the decreasing trend in the NPLs ratio since the beginning of 2016. As of Q3 2017, the ratio records its lowest after-crisis level of 12.2%. The *Decision on the Accounting Write-off of Bank Balance Sheet Assets* is last adopted in August 2017 by the National Bank of Serbia to encourage banks to continue resolving the NPLs in line with the Strategy.

There is some positive development during the period: January-September 2017, accordingly, at the relatively low profitability issue. The pre-tax financial result rises significantly on an annual basis whereat the returns on assets (ROA) and equity (ROE) are gaining momentum. Along this line of thinking, and given the structural improvements of the system, it could be concluded that there is potential for further growth in Serbian banks' performance.

Outlook:

The stable outlook of the Sovereign Rating of the Republic of Serbia reflects the BCRA's opinion that the risks to the country's development are balanced and they currently do not affect their creditworthiness. Economic growth is expected to be supported by the continued progress with the European Union accession process. BCRA do not expect any drastic changes in the political situation to happen in the short term. We believe that the government's commitment to fiscal consolidation would go further.

BCRA would consider upgrading the Sovereign Rating and the Outlook for the Republic of Serbia if the country marks a steady economic performance and positive dynamics in key economic indicators, namely higher GDP growth and reduction in unemployment, complemented by structural reforms. Stable inflow of foreign direct investments and continuous reduction of external imbalances also would have positive impact on country's performance. Further cooperation with the IMF after the completion of the Stand-By Arrangement and progress in the negotiations with the European Union will be important factors for further improvement of the credit rating.

Negative pressures on the Sovereign Rating and the Outlook may arise in case of reversal in government commitment for further fiscal consolidation resulting in a deterioration of the fiscal indicators. A possible intensification in external imbalances and outflow of foreign investment in the country would also negatively affect the rating. Additional factors may stem from the banking system as the diversity of the capital sources creates prerequisites for contagion effects.

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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 Serbia 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 in 2017, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On the 24th of January 2018, Rating Committee of BCRA – CREDIT RATING AGENCY (BCRA) had a session, on which the **Report regarding the review of an unsolicited sovereign rating of Serbia** 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** according to the **Sovereign Rating Methodology**.

The members of the committee considered the political situation in the country, which remains relatively stable both internally and in terms of major foreign policy challenges.

Macroeconomic environment is characterized by some fluctuations but continues to generate growth thanks to the improved investment climate and labour market conditions and hence through consumption growth. The positions of the local currency against the euro and the US dollar are strengthening.

The sustained improvement in public finance efficiency was discussed. The fiscal consolidation in recent years has managed to significantly narrow the budget deficit and the public debt, which decreases the risk concerning debt payments in the short and medium term.

The banking system preserve its growth potential and an improvement in asset quality is observed.

The current sovereign rating and the related outlook have been determined based on the above discussion.

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Tables:

Country	*Development classification*
Republic of Serbia	*Emerging and Developing Europe (IMF classification)*

BASIC MACROECONOMIC INDICATORS

	2017 I-IX	2016 I-IX	2016	2015	2014	2013	2012
GDP, current prices (EUR millions)	26 530	25 199	34 617	33 491	33 319	34 263	31 683
Final consumption	23 566	22 477	30 592	30 444	31 104	31 885	30 307
Gross fixed capital formation	4 848	4 501	6 139	5 926	5 558	5 908	6 707
Net exports	-2 192	-1 848	-2 580	-3 266	-3 614	-3 669	-5 281
Exports	14 249	12 705	17 316	15 632	14 452	14 116	11 700
Imports	16 440	14 553	19 896	18 898	18 066	17 786	16 981
GDP, real growth rate (%)	*1,6*	*2,9*	*2,8*	*0,8*	*-1,8*	*2,6*	*-1,0*
	2017 Q3	**2016 Q3**	**2016**	**2015**	**2014**	**2013**	**2012**
Average net monthly wage (EUR)	400	373	374	368	380	388	366
Unemployment rate (%)	12,9	13,8	15,3	17,7	19,2	22,1	23,9
Activity rate (%)	55,3	54,3	53,3	51,6	51,9	48,4	46,7
	2017 I-XII	**2016 I-XII**	**2016**	**2015**	**2014**	**2013**	**2012**
CPI, annual average rate of change (%)	3,2	1,1	1,1	1,4	2,1	7,9	7,3
Average exchange rate RSD/EUR	121,41	123,12	123,12	120,73	117,31	113,14	113,13
Average exchange rate RSD/USD	107,76	111,29	111,29	108,85	88,54	85,17	88,12

EXTERNAL SECTOR

EUR millions	2017 I-X	2016 I-X	2016	2015	2014	2013	2012
Current account, net	-1 502	-883	-1 075	-1 577	-1 985	-2 098	-3 671
Current account (% of GDP)	-4,1	-2,6	-3,1	-4,7	-6,0	-6,1	-11,6
Goods	-3 065	-2 529	-3 119	-3 993	-4 111	-4 159	-5 634
Services	767	728	907	725	465	313	111
Primary income	-2 094	-1 708	-2 022	-1 658	-1 343	-1 419	-1 097
Secondary income	2 891	2 626	3 159	3 349	3 003	3 166	2 949
Capital account, net	9	-2	-10	-18	7	15	-8
Financial account, net	-1 119	-400	-535	-1 205	-1 705	-1 630	-3 351
Direct investment	-1994	-1577	-1899	-1804	-1236	-1298	-753
EUR millions	**2017 Q3**	**2016 Q3**	**2016**	**2015**	**2014**	**2013**	**2012**
Gross external debt	26 033	25 601	26 488	26 234	25 679	25 644	25 645
Gross external debt (% of GDP)	*70,7*	*74,0*	*76,5*	*78,3*	*77,1*	*74,8*	*80,9*

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Official foreign reserves	10 636	9 552	10 205	10 378	9 907	11 189	10 915
Official foreign reserves (% of GDP)	*28,9*	*27,6*	*29,5*	*31,0*	*29,7*	*32,7*	*34,4*
PUBLIC FINANCE							
EUR millions	**2017 I-XI**	**2016 I-XI**	**2016**	**2015**	**2014**	**2013**	**2012**
Consolidated public revenues	14737	13515	14967	14038	13816	13595	13013
Consolidated public expenditures	13954	13559	15405	15273	16017	15469	15180
Budget balance	783	-44	-439	-1235	-2200	-1875	-2167
Primary budget balance	1755	961	630	-160	-1219	-1039	-1564
General government public debt	23 778	25 067	25 188	25 248	23 197	20 615	18 194
% of GDP							
Consolidated public revenues	*40,0*	*39,0*	*43,2*	*41,9*	*41,5*	*39,7*	*41,1*
Consolidated public expenditures	*37,9*	*39,2*	*44,5*	*45,6*	*48,1*	*45,1*	*47,9*
Budget balance	*2,1*	*-0,1*	*-1,3*	*-3,7*	*-6,6*	*-5,5*	*-6,8*
Primary budget balance	*4,8*	*2,8*	*1,8*	*-0,5*	*-3,7*	*-3,0*	*-4,9*
General government public debt	*63,5*	*72,5*	*73,0*	*75,9*	*71,8*	*61,0*	*57,7*
BANKING SYSTEM							
EUR billions	**2017 IX**	**2016 IX**	**2016**	**2015**	**2014**	**2013**	**2012**
Total assets	27,59	25,73	26,25	25,06	24,54	24,83	25,32
Total deposits	19,15	17,53	18,24	16,52	15,64	15,07	14,94
Total loans	16,99	16,04	15,98	15,50	13,67	14,71	14,77
Non-performing loans (gross)	2,11	3,22	2,80	3,49	3,48	3,45	3,22
Pre-tax financial result	0,45	0,27	0,17	0,08	0,03	-0,02	0,10
Annual growth rates (in %)							
Assets	3,8	5,5	6,4	2,7	4,3	-1,2	8,7
Deposits	5,8	12,5	12,1	6,2	9,5	1,7	11,3
Loans	2,6	21,0	4,7	-0,6	-2,5	-3,8	12,1
Ratios (in %)	**2017 Q3**	**2016 Q3**	**2016**	**2015**	**2014**	**2013**	**2012**
NPLs ratio	*12,2*	*19,5*	*17,0*	*21,6*	*21,5*	*21,4*	*18,6*
Liquidity	*37,0*	*34,6*	*36,9*	*34,3*	*35,6*	*38,5*	*34,5*
Liquidity ratio	*2,2*	*2,2*	*2,1*	*2,1*	*2,2*	*2,4*	*2,1*
ROA	*2,2*	*1,4*	*0,7*	*0,3*	*0,1*	*-0,1*	*0,4*
ROE	*11,0*	*6,9*	*3,4*	*1,6*	*0,6*	*-0,4*	*2,1*

Source: Statistical Office of the Republic of Serbia, the National Bank of Serbia, Ministry of Finance of the Republic of Serbia, the World Bank, the International Monetary Fund, the European Commission, BCRA's database