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# Serbia

## January 2019

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| SOVEREIGN RATING | Initial rating | Review | Review |
|---|---|---|---|
| Date of Rating Committee | 31.07.2017 | 24.01.2018 | 16.01.2019 |
| Date of rating publication | 11.08.2017 | 26.01.2018 | 18.01.2019 |
| Long-term rating | BB- (ns) | BB (ns) | BB (ns) |
| Outlook | Stable | Stable | Positive |
| Short-term rating | B (ns) | B (ns) | B (ns) |

- (ns) – not solicited rating

***BCRA – CREDIT RATING AGENCY AD (BCRA)** is the third fully recognized rating agency in the EU, registered pursuant to Regulation No. 1060/2009 of the European Parliament and of the Council. The credit ratings, assigned by the BCRA are valid throughout the EU and are fully equal to those, of the other agencies, recognized by the European Securities and Markets Authorities, without any territorial or other limitations.*

**"BCRA - CREDIT RATING AGENCY" AD rates Serbia with unsolicited sovereign long-term rating BB (ns) and short-term B (ns) with positive outlook.**

**BCRA's officially adopted Sovereign Rating Methodology has been applied http://www.bcra-bg.com/files/file_330.pdf.**

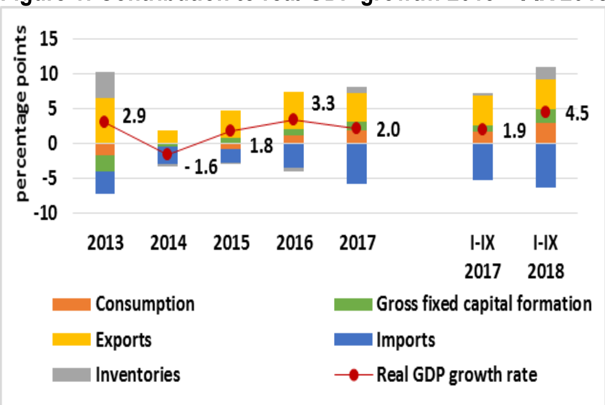
The report has been prepared and the rating – assigned, based on public information, made available by the Statistical Office of the Republic of Serbia, the National Bank of Serbia, Ministry of Finance, the World Bank, the International Monetary Fund, the European Commission, BCRA's database etc. BCRA uses sources of information, which it considers reliable, however, it cannot guarantee the accuracy, adequacy and completeness of the information used.

### Review report:

Following the resignation of Prime Minister Vučić after his election as President, the new government, headed by Ana Brnabić, took office in June 2017 and reaffirmed **EU accession** as a main strategic goal.

Serbia was granted EU candidate status in 2012 and since then has opened 16 out of 35 negotiations chapters. The overall pace of the accession process will depend on Serbia's progress in reforms on rule of law and in the normalisation of their relations with Kosovo. The new nonfinancial 30-month policy-coordination arrangement with the IMF that the government signed in July 2018 is expected to further support the structural reforms.

**Figure 1: Contribution to real GDP growth: 2013 – I-IX 2018**



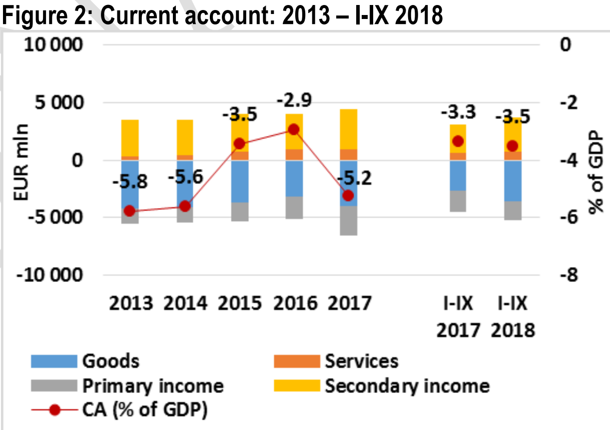

*Source: SORS*

Serbia's **economic growth** has fluctuated in recent years being adversely affected by weather events. However, in 2018, the economic activity regained momentum as the GDP growth notably accelerated to 4.5% in the first nine months of the year, with the largest contribution coming from consumption and investment. Growth of employment and salaries, lower cost of financing, as well as favourable price trends, have all boosted spending, which resulted in 3.2% increase in household final consumption expenditure. Investment activity remained robust, as the gross fixed capital formation picked up to a double-digit growth of 11.5% in the first nine months of 2018. Country's exports increased by 8.3% in real terms, while boosted by the higher domestic demand imports' growth incurred an acceleration to 11.2%. Thus, net exports generated negative impact on the GDP growth.

Growth in the first nine months of 2018 remained widely dispersed across all of the economic sectors with largest positive contribution steaming from the services. Gross value added of the construction sector marked the highest annual growth of 17%, backed by the acceleration of infrastructure investment. The agriculture sector also saw a significant growth of 14.1%. Industrial production expanded by 2.2% in real terms.

Serbia's largest **trade partners** are EU member states and the progress in the approximation of the country to the Union is further accompanied by lowering of barriers to trade in goods. As a member of CEFTA, 17.5% of Serbian exports in 2017 were absorbed by other CEFTA-member countries, among which Bosnia and Herzegovina and Montenegro have largest contribution. In the end of 2018, however, Kosovo unilaterally violated this agreement as imposed duties for imports from Serbia and Bosnia and Herzegovina, which resulted in increased tensions in the region and brought uncertainty for the subsequent economic effects. Russia and China retain their considerable presence in the international trade of Serbia.

**Figure 2: Current account: 2013 – I-IX 2018**




*Source: NBS*

Serbia's **current account** deficit in the period January-September 2018 widened to EUR 1 504 mln (3.5% of the projected GDP) from EUR 1 309 mln (3.3% of GDP) in the same prior year period. The increase of current account deficit was a result of 33.7% higher trade deficit which, however, was partly compensated by the increased surplus on the net services trade, lower investment income outflows and higher secondary income surplus.

The current account deficit remains fully financed by nondebt-generating inflows, as the country has benefited from steady **FDI** inflows. Net FDI inflows in the first nine months of 2018 amounted to EUR 1 851 mln (4.3% of the projected GDP) and were by 4.0% higher compared to the same period of 2017. Foreign investments are well diversified

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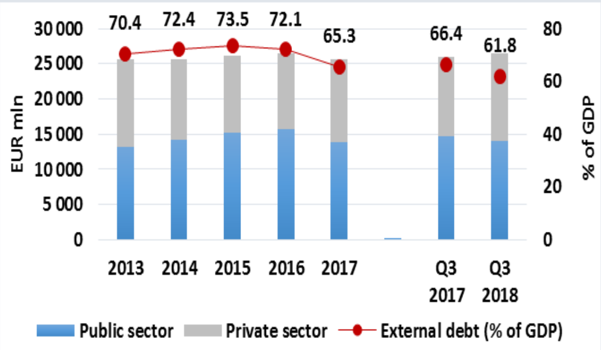
across the industries and one third of them are directed to manufacturing which provides the basis for further growth of exports.

**Figure 3: Gross external debt: 2013 – Q3 2018**

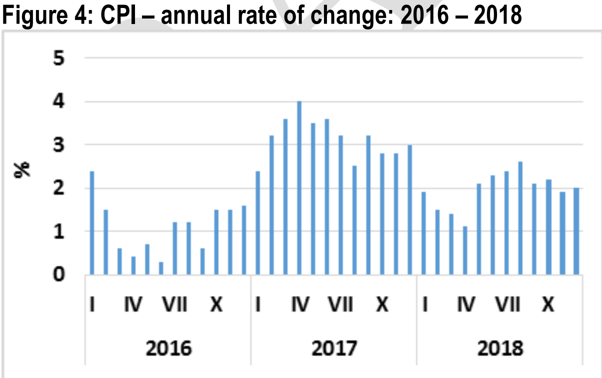



*Source: NBS*

**Gross external debt** at the end of September 2018 amounted to EUR 26 517 mln (61.8% of the projected GDP), which is a nominal increase by EUR 929 mln compared to the end of previous year. The overall increase was mainly prompted by the private sector debt which increased by EUR 844 mln, while public external debt increased by EUR 85 mln. The debt structure by original maturity improved as the short-term debt accounted for 16.3% of total external debt, compared to 18.8% at the end of 2017.

**External liquidity indicators** improved as well. At the end of September 2018, NBS foreign exchange reserves stood at EUR 11 172 mln or 26% of the projected GDP. The level of reserves was sufficient for coverage of more than 5 months of goods and services imports and ensured 258.9% coverage of short-term external debt, enough adequate to reduce the risk of inability to respond to unexpected events occurring on international markets.

**Figure 4: CPI – annual rate of change: 2016 – 2018**




*Source: SORS*

The average annual consumer price **inflation** decelerated to 2.0% in 2018 from 3.2% in 2017, as domestic and global inflationary pressures, prevailing during the year, remained subdued. The greatest contribution to inflation in 2018 came from food prices. Inflationary pressure in next years may arise from the gradual increase of domestic demand but inflation is expected to remain within the lower band of NBS target range (3.0% ± 1.5 p.p.) in the absence of significant supply-side shocks.

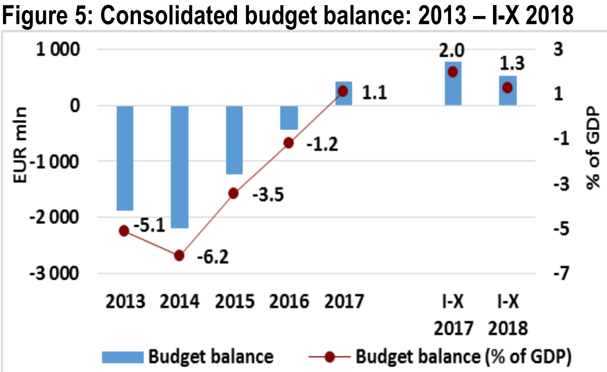
The **Serbian dinar** has remained broadly stable against the euro, as the appreciation pressures have eased in the second half of 2018.

The economic upsurge, additionally boosted by the strong FDI in manufacturing sectors and by services' momentum, favoured the **labour market** development. Employment in Serbia raised and the unemployment continued to decrease, resulting in a further increase of the activity rate of the population to 55.5% as of Q3 2018.

In respond, the **unemployment rate** lowered to 11.3% compared to 12.9% in Q3 2017. The rate, however, remains high as some challenging issues for the market like underemployment, relatively low incomes and undeclared labour activities have still been present.

**GDP per capita** in Serbia (EUR 5 600 in 2017) is much lower than the EU-average (EUR 30 000 in 2017) and also below the measure in neighbouring states like Bulgaria, Romania and Croatia, which hold the last places among the EU-members by this indicator. Measured by purchasing power parity, GDP per capita is almost 3 times lower than the EU-average.

**Figure 5: Consolidated budget balance: 2013 – I-X 2018**




*Source: Ministry of Finance*

The important objectives of fiscal consolidation have been achieved faster than planned. As a

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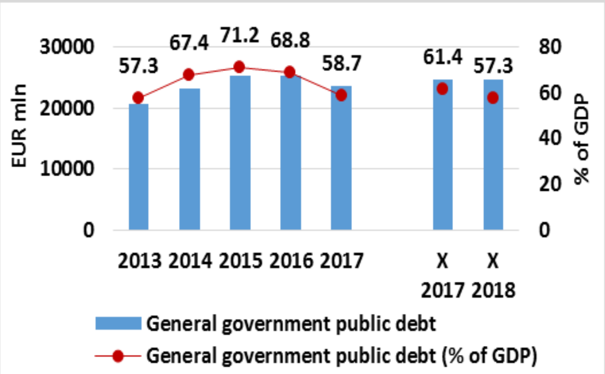
result, in 2017 the **fiscal balance** switched to a surplus for a first time since 2005.

Strong fiscal performance continued in the course of 2018. In the period January-October 2018, consolidated budget revenues recorded a nominal growth of 5.9%, while the consolidated budget expenditures expanded by 8.4% compared to the same prior year period. Backed by higher domestic demand and positive labour market trends, tax revenues increased by 5.5% on an annual basis, with the largest contribution coming from 9.2% higher social contributions and 4% higher VAT payments. Largest increase on the expenditure side recorded the capital expenditures, which were 60.5% higher, compared to first ten months of 2017. Current spending increased by 6.2%, while current interest payments dropped by 9.3% on an annual basis amid lower financing needs of the government.

The fiscal surplus for the period January-October 2018 amounted to EUR 538 mln (1.3% of the projected GDP) while the primary fiscal surplus stood at EUR 1 382 mln (3.2% of the projected GDP). The budget plan for 2018 envisages a consolidated fiscal deficit in the amount of 0.7% of GDP, however, according the execution in the first ten months of the year, we expect better fiscal result and general government budget surplus for a second consecutive year.

The 2019 budget plans for an adequate general government budget deficit of 0.5% of GDP, thus preserving the major fiscal adjustment made in recent years. The budget envisages funds to increase salaries in the public sector and higher capital expenditures for various projects.

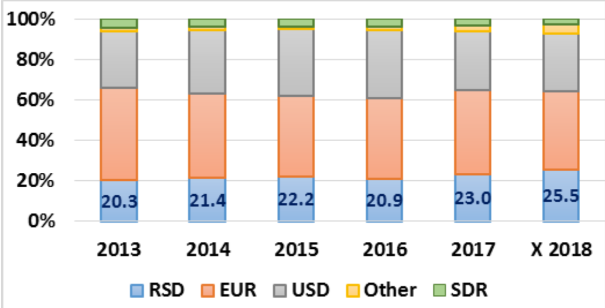
**Figure 6: General government public debt: 2013 – X 2018**




*Source: Ministry of Finance*

**Public debt** follows a firm downward path. General government public debt to GDP ratio has fallen below the risky boundary of 60% in 2017 and continued to decline to 57.3% in October 2018, driven by lower financing needs and faster GDP growth. In nominal terms, general government debt rose by EUR 1 067 mln compared to the end of 2017, reaching EUR 24 617 mln at the end of October 2018.

**Figure 7: Currency structure of Central government debt: 2013 – X 2018**




*Source: Ministry of Finance*

The debt profile continues to improve. The share of debt denominated in national currency increased from 23% at the end of 2017 to 25.5% in October 2018. However, the relatively high share of debt denominated in foreign currency, mainly euros and U.S. dollars, carries risk and could inflate government debt as well as its interest bill in case of unfavourable dinar exchange rate movements. The interest rate risk is relatively low, given the small share of debt contracted at variable rates (18% as of October 2018). The increased maturity profile and the drop in borrowing costs have reduced the refinancing risk of the debt portfolio.

Thanks to the fiscal surplus realized during 2018, early redemptions of Government Bonds were made twice at the end of the year. As a result, debt repayments for 2019 have been further lowered.

**Yield on government securities** have continued to decline, backed by improved fundamentals and credibility of policies. The costs of government borrowing have marked a falling trend since end-2012, triggered by the global developments in terms of policy relaxation. Further the drop was also backed by domestic factors - the successful application of fiscal consolidation measures, relatively stable exchange rate and low inflation.

The current stance of monetary policy remains appropriate. The **key policy rate** was continuously reduced in recent years in line with the domestic and global financial environment. NBS cut the key repo rate by 0.25 p.p. to 3.25% in March, then

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lowered it further to 3.0% in April 2018 and decided to keep it unchanged at this level till the end of the year. The monetary policy easing in the context of low inflationary pressures has provided additional support to the credit activity and economic growth.

Serbian **banking system** has been maintaining high levels of liquidity and capital adequacy, as reported at 35.0% and 22.8% for Q3 2018, respectively. Indicators of profitability also remain close to their favourable levels demonstrated in 2017.

Lending to the non-financial sector (NFS) has recovered and deposits from NFS have kept expanding. Along with that, the measures taken on the non-performing loans resolution have given visible results. The trend in the NPLs ratio have become decreasing since the beginning of 2016 and as of Q3 2018, the ratio records a level of 6.4% (down by 5.8p.p. on an annual basis).

The NFS outstanding bank receivables and payables preserve their dual currency structure with prevalence of euro over the Serbian dinar, and the local currency strengthening its position. At the end of the year, the government and the NBS reaffirmed their commitment to further extend the dinarisation in the financial system and promoting development of the dinar securities market. Serbian authorities signed a new *Memorandum on the Dinarisation Strategy*[1] also presenting a review of the achievements that have been made since the release of the previous *Memorandum* of 2012. Biggest progress in dinarisation is reported to have been made in the segment of household lending so far. Additional measures and activities for reducing the foreign currency risk in the system are outlined, such as continued stimulation of dinar savings and loans use by preferential regulatory treatment or subsidised loan programmes.

**Outlook:**

The **positive outlook** of the Sovereign Rating of the Republic of Serbia reflects BCRA's opinion that risks are broadly balanced. Serbia's credit rating is constrained by its low GDP per capita, institutional weaknesses, unresolved Kosovo conflict and still high debt burden. On the other hand, the notable fiscal consolidation in recent years has reduced the risks to the fiscal position. Also, the country attracts large-scale foreign investments and the external imbalances remain contained with comfortable level of foreign exchange reserves. However, Serbian economy remains susceptible to spillovers and global market volatility. The EU accession process and the partnership with the IMF are expected to serve as an anchor for government's reform agenda.

**Positive pressures** on the Sovereign Rating and the Outlook may arise in case of:

- Implementation of additional structural reforms, raising the country's growth potential;
- Stronger than anticipated fiscal results, lowering the public debt to GDP ratio;
- Reduction in external imbalances;

**Negative pressures** on the Sovereign Rating and the Outlook may arise in case of:

- Fiscal consolidation reversal, putting Serbia's public debt on an upward path;
- Intensification in external imbalances and capital outflow related to sudden shift in investors' sentiment and risk aversion;
- Increased political instability.

[1] *The full text of the document could be found at: https://www.nbs.rs/internet/english/30/Memorandum_Dinarisation_Strategy_2018.pdf*

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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.*

Please, visit www.bcra-bg.com to review BCRA's full policy on unsolicited credit/sovereign ratings.

## 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 until the end of 2018, with some exceptions, for which data is released more frequently.

## Summary of the minutes of the Rating Committee:

On January 16, 2019, 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 **Rating Model** and analysed in the **Credit Rating Report** according to the **Sovereign Rating Methodology**.

The key points discussed by the rating committee were: 1) the growth potential of the Serbian economy; 2) macroeconomic stability and imbalances; 3) the path towards EU membership and the institutional framework; 4) the successful fiscal consolidation; 5) the current account deficit and the FDIs as its financing source; 6) the structure of country's external debt and the adequacy of international reserves; 7) the development of the banking system and the visible improvement in asset quality.

**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) |

| MAIN MACROECONOMIC INDICATORS* | | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2018 I-IX | 2017 I-IX | 2017 | 2016 | 2015 | 2014 | 2013 |
| GDP, current prices (EUR millions) | 31 195 | 28 435 | 39 183 | 36 723 | 35 716 | 35 467 | 36 427 |
| Final consumption | 27 011 | 24 817 | 34 089 | 31 913 | 31 578 | 32 472 | 33 090 |
| Gross fixed capital formation | 5 731 | 4 879 | 6 953 | 6 224 | 5 989 | 5 657 | 6 001 |
| Net exports | -2 349 | -1 678 | -2 583 | -1 766 | -2 493 | -2 864 | -2 993 |
| Exports | 16 089 | 14 652 | 19 804 | 17 853 | 16 170 | 14 924 | 14 517 |
| Imports | 18 439 | 16 329 | 22 386 | 19 619 | 18 663 | 17 788 | 17 510 |
| GDP, real growth rate (%) | 4.5 | 1.9 | 2.0 | 3.3 | 1.8 | -1.6 | 2.9 |
| | Q3 | Q3 | | | | | |
| Average net monthly wage (EUR) | 414 | 399 | 395 | 374 | 368 | 380 | 388 |
| Unemployment rate[1] (%) | 11.3 | 12.9 | 13.5 | 15.3 | 17.7 | 19.2 | 22.1 |
| Activity rate[1] (%) | 55.5 | 55.3 | 54.0 | 53.3 | 51.6 | 51.9 | 48.4 |
| | I-XII | I-XII | | | | | |
| CPI, annual average rate of change (%) | 2.0 | 3.0 | 3.0 | 1.6 | 1.5 | 1.7 | 2.2 |
| Average exchange rate RSD/EUR | 118.27 | 121.34 | 121.34 | 123.12 | 120.73 | 117.31 | 113.14 |
| Average exchange rate RSD/USD | 100.28 | 107.50 | 107.50 | 111.29 | 108.85 | 88.54 | 85.17 |

| EXTERNAL SECTOR | | | | | | | |
|---|---|---|---|---|---|---|---|
| *EUR million* | 2018 Q3 | 2017 Q3 | 2017 | 2016 | 2015 | 2014 | 2013 |
| Current account, net | -1 504 | -1 309 | -2 051 | -1 075 | -1 234 | -1 985 | -2 098 |
| Goods | -3 533 | -2 643 | -3 997 | -3 119 | -3 645 | -4 111 | -4 159 |
| Services | 762 | 641 | 966 | 907 | 729 | 465 | 313 |
| Primary income | -1 657 | -1 807 | -2 533 | -2 022 | -1 658 | -1 343 | -1 419 |
| Secondary income | 2 924 | 2 500 | 3 514 | 3 159 | 3 340 | 3 003 | 3 166 |
| Official foreign reserves | 11 172 | 10 636 | 9 962 | 10 205 | 10 378 | 9 907 | 11 189 |
| Gross external debt | 26 517 | 26 009 | 25 588 | 26 494 | 26 234 | 25 679 | 25 644 |
| International investment position | -36 903 | - | -35 655 | -34 712 | -33 907 | -32 494 | -30 640 |
| *% of GDP[2]* | | | | | | | |
| Current account, net | -3.5 | -3.3 | -5.2 | -2.9 | -3.5 | -5.6 | -5.8 |
| Goods | -8.2 | -6.7 | -10.2 | -8.5 | -10.2 | -11.6 | -11.4 |
| Services | 1.8 | 1.6 | 2.5 | 2.5 | 2.0 | 1.3 | 0.9 |
| Primary income | -3.9 | -4.6 | -6.5 | -5.5 | -4.6 | -3.8 | -3.9 |
| Secondary income | 6.8 | 6.4 | 9.0 | 8.6 | 9.4 | 8.5 | 8.7 |
| Official foreign reserves | 26.0 | 27.1 | 25.4 | 27.8 | 29.1 | 27.9 | 30.7 |
| Gross external debt | 61.8 | 66.4 | 65.3 | 72.1 | 73.5 | 72.4 | 70.4 |
| International investment position | -91.8 | - | -96.9 | -100.3 | -101.2 | -97.5 | -89.4 |

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| PUBLIC FINANCE | | | | | | | |
|---|---|---|---|---|---|---|---|
| *EUR million* | **2018 X** | **2017 X** | **2017** | **2016** | **2015** | **2014** | **2013** |
| Consolidated public revenues | 14 516 | 13 296 | 16 264 | 14 967 | 14 038 | 13 816 | 13 595 |
| Consolidated public expenditures | 13 978 | 12 514 | 15 833 | 15 405 | 15 273 | 16 017 | 15 469 |
| Budget balance | 538 | 782 | 431 | -439 | -1 235 | -2 200 | -1 875 |
| Primary budget balance | 1 382 | 1 684 | 1 430 | 630 | -160 | -1 219 | -1 039 |
| General government public debt | 24 617 | 24 644 | 23 551 | 25 188 | 25 248 | 23 197 | 20 615 |
| *% of GDP[2]* | | | | | | | |
| Consolidated public revenues | 33.8 | 34.1 | 41.5 | 40.8 | 39.3 | 39.0 | 37.3 |
| Consolidated public expenditures | 32.6 | 32.1 | 40.4 | 41.9 | 42.8 | 45.2 | 42.5 |
| Budget balance | 1.3 | 2.0 | 1.1 | -1.2 | -3.5 | -6.2 | -5.1 |
| Primary budget balance | 3.2 | 4.3 | 3.6 | 1.7 | -0.4 | -3.4 | -2.9 |
| General government public debt | 57.3 | 61.4 | 58.7 | 68.8 | 71.2 | 67.4 | 57.3 |

| BANKING SYSTEM | | | | | | | |
|---|---|---|---|---|---|---|---|
| % | **2018 Q3** | **2017 Q3** | **2017** | **2016** | **2015** | **2014** | **2013** |
| Total capital adequacy | 22.8 | 22.5 | 22.6 | 21.8 | 20.9 | 20.0 | 20.9 |
| Liquid assets to total assets | 35.0 | 37.0 | 35.1 | 38.9 | 40.5 | 42.2 | 41.0 |
| Non-performing loans to total loans | 6.4 | 12.2 | 9.8 | 17.0 | 21.6 | 21.5 | 21.4 |
| NPL coverage by provisions | 61.3 | 62.2 | 58.1 | 67.8 | 62.3 | 54.9 | 50.9 |
| ROA | 2.1 | 2.2 | 2.1 | 0.7 | 0.3 | 0.1 | -0.1 |
| ROE | 10.7 | 11.0 | 10.5 | 3.3 | 1.5 | 0.6 | -0.4 |

*[1] Unemployment rate and activity rate of population aged 15 years and over, Labour Force Survey.*
*[2] The GDP ratios for 2018 are calculated on the basis of GDP amounting to RSD 5 074 200 mln (MoF estimate).*

* Please notice that the SORS published new, revised data on annual GDP and its composition for the 2005 –2017 period. The revision of GDP data included new sources of data and methodological improvements which should result in greater comprehensiveness, precision and reliability of data.

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