BCRA CREDIT RATING AGENCY

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Serbia

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SOVEREIGN RATING	Initial rating	Review	Review
Date of Rating Committee	31.07.2017	01.07.2021	30.12.2021
Date of rating publication	11.08.2017	02.07.2021	07.01.2022
Long-term rating	BB- (ns)	BB+ (ns)	BB+ (ns)
Outlook	Stable	Stable	Stable
Short-term rating	B (ns)	B (ns)	B (ns)

- (ns) – not solicited rating

* *The full rating history is available at: https://www.bcra-bg.com/en/ratings/serbia-rating*

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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.

BCRA - CREDIT RATING AGENCY AD **affirms** the **unsolicited** long-term and short-term sovereign rating of Serbia and **maintains** the outlook related to them:

Long-term rating: **BB+ (ns)**
Short-term rating: **B- (ns)**
Outlook: **Stable**

BCRA's officially adopted **Sovereign Rating Methodology has been applied:** *https://www.bcrabg.com/files/Sovereign_Methodology_2019_en.pdf*

Notes:

1) Prior to the present publication, the credit rating and the rating outlook were disclosed to the rated entity. Following that disclosure amendments in the credit rating and the rating outlook have not been executed;
2) During the last two years, BCRA Credit Rating Agency AD has not provided ancillary services to the rated entity or a related third party;
3) The users of the rating can find information on the meaning of each rating category in the Global Scale (https://www.bcra-bg.com/files/global_scale_en.pdf). The definition of default can be found in the Sovereign rating Methodology (https://www.bcra-bg.com/files/Sovereign_Methodology_2019_en.pdf)

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Review report:

Serbia advanced on their main strategic goal - namely the **EU accession** - opening talks on the following negotiation chapters: Transport policy (14), Energy (15), Trans-European networks (21), and Environment and climate change (27) at the EU–Serbia Intergovernmental Conference on the 14th of December 2021. Along with the achievements in the area of the rule of law, judiciary, fight against corruption and fight against organised crime, the country is awaited to progress on the normalisation of relations with Kosovo, which is essential for the overall pace of the accession process. The country has opened 22 out of 35 negotiation chapters so far, of which two chapters have been provisionally closed.

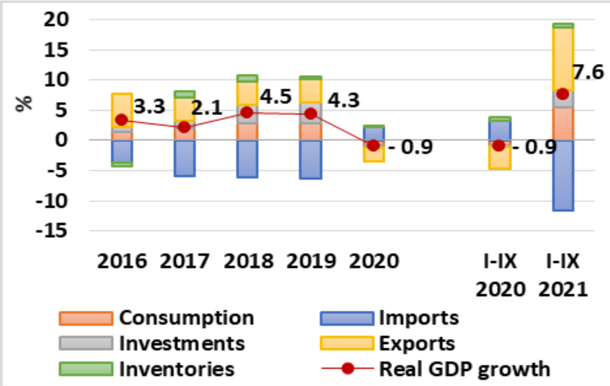
Earlier this year the government publicly declared an engagement in promoting ESG awareness and projects in the field of climate change mitigation and environmental protection and adopted a Green Bond Framework. Serbia has joined in global and regional initiatives to move towards a green economy.

The authorities' commitment to addressing the outstanding structural reform needs and ensuring a green recovery has been monitored by the IMF under the Policy Coordination Instrument signed in June 2021. In the first review of Serbia's economic programme, the IMF appraised the short and mid-term monetary and fiscal policies as broadly appropriate and supportive.

Regarding domestic affairs, the parliamentary election from June 2020 concreted the leading position of the Serbian Progressive Party, yet, a new general vote is planned to hold on the 3rd of April 2022 together with the regular presidential elections and the local elections in the capital Belgrade. Serbian authorities should hold a constitutional referendum in January 2022 as well, for bringing the judiciary legislation into line with the EU's and should also handle environmental protests with roadblocks set up over a lithium mine project.

After a mild contraction of 0.9% in 2020, the Serbian economy posted a strong recovery. The **real GDP** rose by 7.6% YoY on average for the first three quarters of 2021, driven by robust domestic demand while net exports provided a slightly negative contribution.

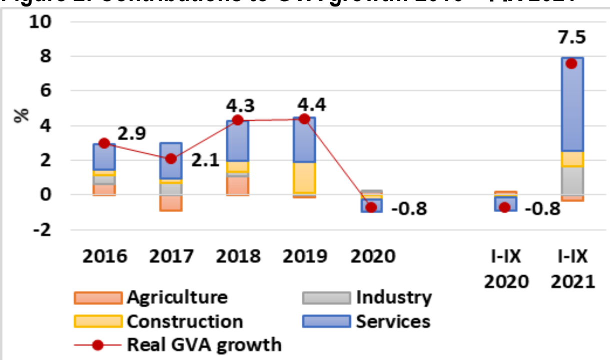
Figure 1: Contributions to GDP growth: 2016 – I-IX 2021



Source: SORS

Final consumption annually expanded by 7.8% backed by improved consumer confidence and favourable labour market trends, namely increase in employment and sustained real wage growth. Investment activity also provided a strong push to the economic recovery. Gross fixed capital formation increased by 14% YoY reflecting the continued execution of large public investment projects as well as the acceleration of private investments due to reduced uncertainty in doing business. Given the recovery in external demand and last year's low base, Serbian exports of goods and services posted a double-digit growth of 21.6% in real terms. In parallel, imports were fuelled by the pickup in domestic demand and also rebounded at a strong rate of 20.9% YoY.

Figure 2: Contributions to GVA growth: 2016 – I-IX 2021



Source: SORS

On the production side, the rebound of economic activity was broad-based, with almost all sectors contributing positively to the 7.5% annual increase in **gross value added** (GVA). The industrial activity expanded by 6.9% YoY on average in the first nine months of 2021 but its performance decelerated significantly in Q3. The construction sector also posted a strong annual growth of 15.5% backed by

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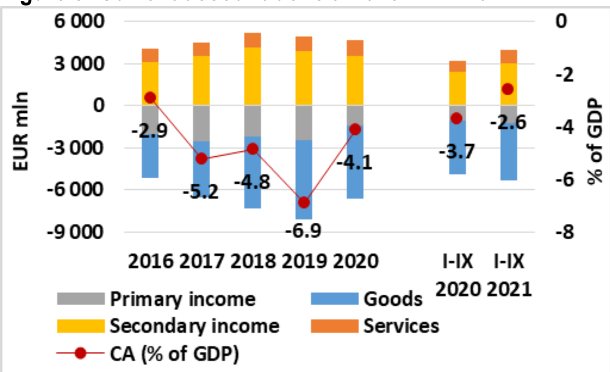
the implementation of large infrastructure projects. The most significant positive contribution to the GVA growth rate came from the services sector, which rebounded by 8.7% YoY.

Figure 3: Current account deficit: 2016 – I-IX 2021

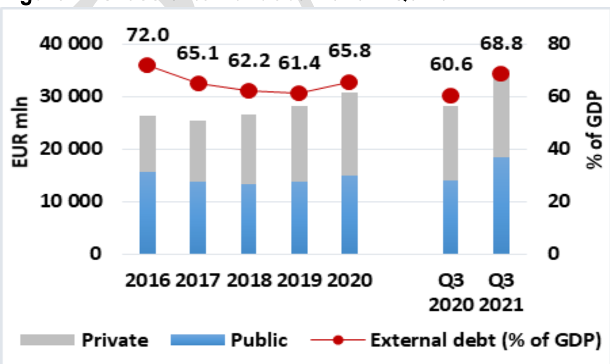


Source: NBS

In the first nine months of 2021, Serbia's **current account** posted a deficit of EUR 1 313 mln, compared to a deficit of EUR 1 714 mln a year ago. The improvement resulted from increases in secondary income surplus and services surplus, which rose by 22.2% and 39.6%, respectively. On the other hand, the deficit in trade in goods slightly increased by 7.4%, and the primary income deficit expanded by 13.9%, thus, partly limiting the overall improvement in the external position.

Over the past five years, negative current account balances have been more than fully financed from steady inflows of **foreign direct investment,** which remained resilient in 2020 despite the unfavourable global investment sentiments related to the pandemic. In January-September 2021, net FDI inflow sustained strong growth, annually increasing by 58.4%.

Figure 4: Gross external debt: 2016 – Q3 2021

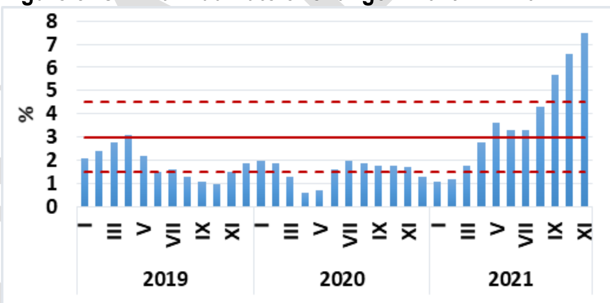


Source: NBS

As of Q3 2021, **gross external debt** stood at EUR 35 233 mln (68.8% of GDP[1]), increasing by EUR 7 006 against the end of 2020. The increase was mainly prompted by the government's external financing, while the indebtedness of enterprises and banks showed a more moderate increase. Concurrently, the relative share of short-term debt by remaining maturity decreased to 13.8%.

The resilience to external shocks is secured by an adequate **international reserve** position**.** Eurobond issuances enabled the increase in reserves, which reached EUR 16 803 mln as of end-September 2021 covering 6.5 months' worth of the country's imports or 346.6% of short-term external debt at remaining maturity.

Figure 5: CPI – annual rate of change: I 2019 – XI 2021



Source: SORS

After moving around the lower bound of the inflation target band (3% ± 1.5 p.p.) in the first quarter, the annual **CPI** jumped to 7.5% as of November 2021. Inflation is accelerating mostly due to the low-base effect and amid rising international energy prices as well as to the higher unprocessed food prices related to drought. Price growth is, however, expected to return within the target band in 2022 due to the temporary nature of these drivers. In parallel, the **dinar** has remained stable against the euro, thus, the central bank helping to anchor inflation expectations.

The pandemic-induced crisis affected in a limited way the **labour market** outcome in 2020 as the pace of improving market conditions slowed down. During the lockdown in Q1 2021, the unemployment rate recorded 12.8% (being 9.7% on average for 2020) and then gradually eased to 10.5% as of Q3 2021. The biggest positive contribution to employment dynamics in the last quarter came from acceleration in construction, manufacturing

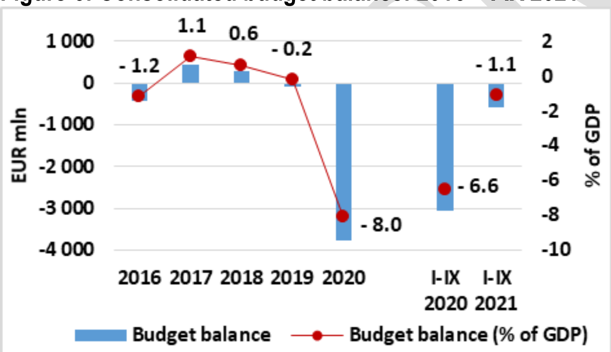
[1] GDP ratio was calculated using the sum of GDP in the four preceding quarters.

and agriculture activities' rebound while the other economic sectors displayed different annual movements amid overall rising participation rates.
The moderate real **wage** rise persisted in the first nine months of 2021 standing at 8.8% (net) after it had only slightly decelerated in 2020 to a 7.7% growth with no sector recording a decline. The income policy of the Serbian government envisages a new minimum wage rise from the beginning of 2022 by 9.4% to RSD 35 012 (or apr. EUR 298) as well as further public sector wage increases.

GDP per capita made a slight positive adjustment in 2020 to EUR 6 780 from EUR 6 620 in 2019, which is, however, much lower than the EU-average (EUR 29 890 in 2020) and below the measure in neighbouring states like Bulgaria, Romania, and Croatia, which hold the last places among the member states. Measured by purchasing power parity, GDP per capita accounted for 43.3% of the EU average as of 2020.

To cushion the economic and social effects of the COVID-19 shock, the government deployed a prompt policy response, thus, the **fiscal** gap escalated to 8.0% of GDP in 2020. Following two packages of support measures in 2020, additional measures totalling about 4.2% of GDP were introduced in 2021.

Figure 6: Consolidated budget balance: 2016 – I-IX 2021

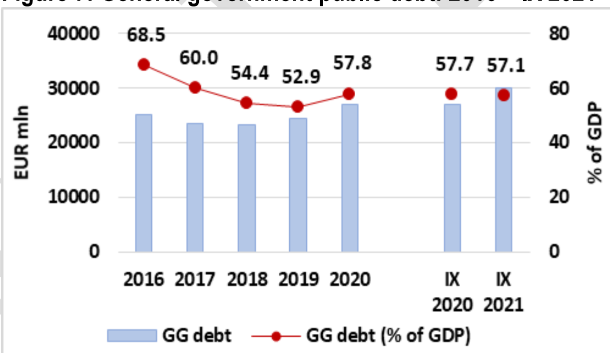


Source: Ministry of Finance

In January – September 2021, total budget revenues posted a double-digit annual growth of 23.1% reflecting the robust expansion of the tax base as well as repayments of deferred taxes. In parallel, total expenditures rose by a modest rate of 3.9% in which current expenditures decreased by 0.1% while capital expenditures recorded a strong annual increase of 51.3%. As a result, the general government budget posted a deficit of EUR 579 mln (1.1% of GDP projected), largely reducing against the EUR 3 069 mln (6.6% of GDP) deficit in the same prior-year period.

Given the improved fiscal outlook due to a stronger than anticipated recovery of economic activity and revenue overperformance, a second supplementary budget for 2021 was adopted in October moderating the deficit target from 6.9 to 4.9% of GDP. In line with the expiry of one-off government support measures, the budget deficit for 2022 is planned at 3% of GDP while the medium-term fiscal plan envisages its gradual reduction to 1% of GDP by 2024.

Figure 7: General government public debt: 2016 – IX 2021



Source: Ministry of Finance

Thanks to fiscal discipline and cautious debt management, Serbia's **government debt**-to-GDP ratio has followed a firm downward path, falling to 52.9% in 2019, but the large financing needs caused by the pandemic reversed the trend, pushing the general government debt to 57.8% of GDP at the end of 2020.

In the first nine months of 2021, the general government debt stock increased by EUR 2 878 mln to EUR 29 934 mln (57.1% of the projected GDP), in which central government debt amounted to EUR 29 595 mln, while the relative share of external debt increased to 60.6%, from 57.1% as of end-2020.

Serbia has been actively financing from the capital markets both locally and internationally. The country has successfully tapped the foreign market placing three emissions in 2021 (a EUR 1 bln Eurobond with a 12-year maturity in February; a EUR 750 mln Eurobond with the longest maturity so far of 15-year and a EUR 1 bln Green Eurobond with a 7-year maturity, both in September), proving the trust of international investors. The green Eurobond achieved the lowest ever coupon rate for

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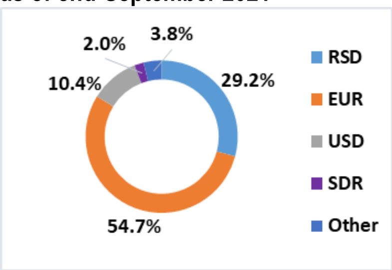
the issuer of 1.00% on the international market and will be used for projects from the green agenda. In addition, aiming to reduce the pressure of liabilities falling due at the beginning of 2022, early redemption on a government bond issued in dinars was accomplished also in September 2021.

Figure 8: Currency structure of General Government debt as of end-September 2021



Source: Ministry of Finance

Despite the recent increase, government debt is expected to resume a clear downward trajectory next year, falling to 53.8% of GDP by the end of 2024 (according to the revised fiscal strategy), while vulnerabilities are mitigated by improved **debt structure**. The interest rate risk remains relatively low, given the small share of the public debt contracted at variable rates (12.3%). Besides, the extension of the average maturity of outstanding debt, and lower borrowing costs have decreased the refinancing risk. However, the still high share of foreign currency-denominated debt (70.8% of total GG debt) represents a risk as it could inflate the public debt level in case of unfavourable exchange rate movements of the dinar.

The sustained accommodative **monetary policy** proved appropriate in mitigating the negative effects of the crisis and supporting economic recovery. In line with the rising inflationary pressures, however, the National Bank of Serbia commenced tightening the monetary conditions in October 2021 as it raised the average repo rate but kept the key policy rate at 1.00% (since December 2020). In addition, the NBS ended repo securities auctions considering the excess liquidity in the system.

The lowered price of dinar credit in line with reliefs in repayment counter to the crisis gave impetus to lending in 2020. Following the acceleration from the previous year, credit growth of the non-financial sector eased in Q1-Q3 2021 in both segments – households (3.7% YoY growth) and companies (8.9%) remaining supported by the state Guarantee Scheme. The NPL ratio shrank to a record low of 3.7% in 2020 and following the outpacing growth of total loans to non-performing loans, it reached 3.6% as of Q3 2021. It is expected to grow in the mid-term but the maintenance of relatively high coverage by provisions (59.3%) mitigates the ensuing risk.

The **banking system** stays sound in securing financial stability and favourable financing conditions despite the enhanced consolidation. The steady upward trend in domestic deposits continues to support the high level of liquidity (LCR stood at 222%) and capital adequacy (21.7% in Q3 2021). The profitability indicators, ROA and ROE, decelerated (to 1.1% and 6.5%, respectively) due to the narrowed income in 2020, which has been resuming in 2021, thus, ROA reached 1.2% and ROE: 7.4% as of September.

Outlook:

The **stable outlook** of the Sovereign Rating of Serbia reflects the opinion that risks are broadly balanced. The economic results surprised on the upside owing to the sizeable and prompt policy support. After a much less severe contraction in 2020, a strong economic recovery is underway, supported by private consumption and large public investments. The budget for 2022 envisages a reduction in the fiscal deficit to 3% of GDP, which will help the public debt to resume a downward trend. In addition, external vulnerabilities are mitigated by a secure level of foreign exchange reserves and resilient FDI inflows, while the banking system remains stable. However, downside risks associated with the pandemic evolution are still present.

Positive pressures on the Sovereign Rating and/or the Outlook would be considered:
- Implementation of important structural reforms, raising economy's growth potential;
- Stronger than anticipated fiscal results;
- Sustained reduction in external imbalances.

Negative pressures on the Sovereign Rating and/or the Outlook may arise in case of:
- Continued fiscal loosening, leading to a material increase in public debt;
- Intensification in external imbalances and capital outflows related to a sudden shift in investors' sentiments;
- Diminishing foreign reserve buffer.

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Regulatory announcements

Rating initiative:

This rating is unsolicited

Unsolicited sovereign rating	
With Rated Entity or Related Third Party Participation	NO
With Access to Internal Documents	NO
With Access to Management	NO

The complete version of BCRA's policy on unsolicited credit/sovereign ratings can be downloaded through the following link: https://www.bcra-bg.com/files/policy_unsolicited_rating_en.pdf

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, except for 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 2021.

Summary of the minutes of the Rating Committee:

On December 30, 2021, the Rating Committee of BCRA – CREDIT RATING AGENCY (BCRA) had a session, on which the **Report regarding the affirmation of the unsolicited sovereign rating of Serbia** was discussed**.** The session was headed by Dr. Kiril Grigorov - chairmen of the Rating Committee.

The members of the **Rating Committee** reviewed numerous qualitative and quantitative risk factors included in the **Sovereign Rating Model** and analysed in the **Sovereign Rating Report** in accordance with our **Sovereign Rating Methodology.**

Key points discussed included: 1) domestic politics and international relations; 2) macroeconomic fundamentals and growth prospects; 3) external metrics and reserves adequacy; 4) fiscal policy; 5) public debt sustainability analysis, and 6) banking system developments.

The sovereign ratings and the related outlook have been affirmed 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							
	2021 I-IX	2020 I-IX	2020	2019	2018	2017	2016
GDP, current prices (EUR mln)	38 480	34 060	46 796	46 005	42 892	39 235	36 779
Final consumption	31 961	28 902	39 350	39 033	36 875	34 138	31 905
Gross fixed capital formation	8 312	6 998	10 036	10 335	8 596	6 959	6 274
Inventories	1 022	1 065	1 287	1 207	1 121	721	375
Net exports	-2 815	-2 905	-3 877	-4 570	-3 700	-2 584	-1 775
Exports of goods and services	20 877	16 101	22 574	23 468	21 633	19 803	17 844
Imports of goods and services	23 692	19 007	26 451	28 037	25 332	22 386	19 619
Real GDP growth (%)	7.6	-0.9	-0.9	4.3	4.5	2.1	3.3
Average net monthly wage (EUR)	548	504	511	466	420	395	374
Unemployment rate[1] (%)	10.5	9.8	9.7	11.2	13.7	14.5	16.4
GDP per capita[2] (EUR)	-	-	6 780	6 620	6 140	5 590	5 210
CPI annual, period average (%)	3.0	1.5	1.5	1.9	2.0	3.2	1.1
Average exchange rate RSD/EUR	117.57	117.58	117.58	117.85	118.27	121.34	123.12
Average exchange rate RSD/USD	98.27	104.67	103.03	105.28	100.28	107.50	111.29

EXTERNAL SECTOR							
EUR mln	2021 I-IX	2020 I-IX	2020	2019	2018	2017	2016
Current account, net	-1 313	-1 714	-1 929	-3 161	-2 076	-2 051	-1 075
Goods	-4 085	-3 803	-5 201	-5 623	-5 085	-3 997	-3 119
Services	1 024	733	1 102	1 012	995	966	907
Primary income	-1 241	-1 090	-1 425	-2 479	-2 182	-2 533	-2 022
Secondary income	2 990	2 445	3 595	3 929	4 197	3 514	3 159
Net FDI	2 719	1 717	2 938	3 551	3 157	2 418	1 899
Official foreign reserves	16 803	13 030	13 492	13 378	11 262	9 962	10 205
Gross external debt	35 233	28 227	30 787	28 254	26 662	25 526	26 494
International investment position	-43 352	-42 276	-42 274	-40 478	-37 555	-35 579	-34 672
% of GDP[3]							
Current account, net	-2.6	-3.7	-4.1	-6.9	-4.8	-5.2	-2.9
Goods	-8.0	-8.2	-11.1	-12.2	-11.9	-10.2	-8.5
Services	2.0	1.6	2.4	2.2	2.3	2.5	2.5
Primary income	-2.4	-2.3	-3.0	-5.4	-5.1	-6.5	-5.5
Secondary income	5.8	5.2	7.7	8.5	9.8	9.0	8.6
Net FDI	5.3	3.7	6.3	7.7	7.4	6.2	5.2
Official foreign reserves	32.8	28.0	28.8	29.1	26.3	25.4	27.7
Gross external debt	68.8	60.6	65.8	61.4	62.2	65.1	72.0
International investment position	-84.6	-90.7	-90.3	-88.0	-87.6	-90.7	-94.3

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PUBLIC FINANCE							
EUR million	**2021 I-IX**	**2020 I-IX**	**2020**	**2019**	**2018**	**2017**	**2016**
Consolidated public revenues	16 749	13 610	19 178	19 334	17 800	16 264	14 967
Consolidated public expenditures	17 328	16 678	22 944	19 428	17 528	15 833	15 405
Budget balance	-579	-3 069	-3 766	-94	272	431	-439
Primary budget balance	256	-2 328	-2 828	830	1 191	1 430	630
Central government debt	29 595	26 605	26 669	23 944	23 015	23 222	24 820
Internal debt	11 670	11 216	11 434	9 993	9 568	9 298	9 149
External debt	17 925	15 388	15 235	13 951	13 446	13 923	15 671
General government debt	29 934	27 007	27 056	24 355	23 328	23 551	25 188
% of GDP[4]							
Consolidated public revenues	32.0	29.1	41.0	42.0	41.5	41.5	40.7
Consolidated public expenditures	33.1	35.6	49.0	42.2	40.9	40.4	41.9
Budget balance	-1.1	-6.6	-8.0	-0.2	0.6	1.1	-1.2
Primary budget balance	0.5	-5.0	-6.0	1.8	2.8	3.6	1.7
Central government debt	56.5	56.9	57.0	52.0	53.7	59.2	67.5
Internal debt	22.3	24.0	24.4	21.7	22.3	23.7	24.9
External debt	34.2	32.9	32.6	30.3	31.3	35.5	42.6
General government debt	57.1	57.7	57.8	52.9	54.4	60.0	68.5

BANKING SYSTEM							
%	**2021 Q3**	**2020 Q3**	**2020**	**2019**	**2018**	**2017**	**2016**
Total capital adequacy	21.7	22.4	22.4	23.4	22.3	22.6	21.8
Liquid assets to total assets	38.6	36.8	37.3	36.0	35.7	35.1	38.9
Non-performing loans to total loans	3.6	3.4	3.7	4.1	5.7	9.8	17.0
NPL coverage by provisions	59.3	62.4	59.0	61.5	60.2	58.1	67.8
ROA	1.2	1.4	1.1	1.8	2.2	2.1	0.7
ROE	7.4	8.2	6.5	9.8	11.3	10.5	3.3

[1] Unemployment rate of population aged 15 years and over, Labour Force Survey. Data in the first two columns refer to the Q3 of the respective year;
[2] Eurostat data;
[3] The GDP ratios for I-IX 2020 and I-IX 2021 are calculated using the sum of nominal GDP in the four preceding quarters;
[4] The GDP ratios for 2021 are calculated on the basis of GDP amounting to RSD 6 162 765 mln (MoF estimate).

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*