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Serbia

July 2019

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SOVEREIGN RATING	Initial rating	Review	Review	Review
Date of Rating Committee	31.07.2017	24.01.2018	16.01.2019	05.07.2019
Date of rating publication	11.08.2017	26.01.2018	18.01.2019	12.07.2019
Long-term rating	BB- (ns)	BB (ns)	BB (ns)	BB (ns)
Outlook	Stable	Stable	Positive	Positive
Short-term rating	B (ns)	B (ns)	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 positive outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied https://www.bcra-bg.com/files/Sovereign_Methodology_2014_en.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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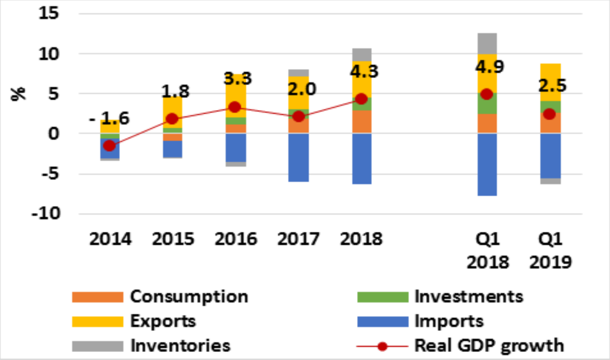
Review report:

During the first half of 2019, geopolitical and regional tensions continued to characterise political situation of Serbia. Despite the weekly anti-government protests in the country, the institutional and macroeconomic environment remained broadly stable.

EU accession is a main strategic goal for Serbia, as the country has currently opened 17 out of 35 negotiations chapters, and has just signed a contract for pre-accession funds of substantial amount. 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. Concurrently, IMF reviews on the policy coordination instrument over its first year pointed that the reform program remained broadly on-track with all end-March 2019 quantitative targets met. According to IMF staff, most reform targets had been implemented, although some with delays.

Figure 1: Contribution to real GDP growth: 2014 – Q1 2019



Source: SORS

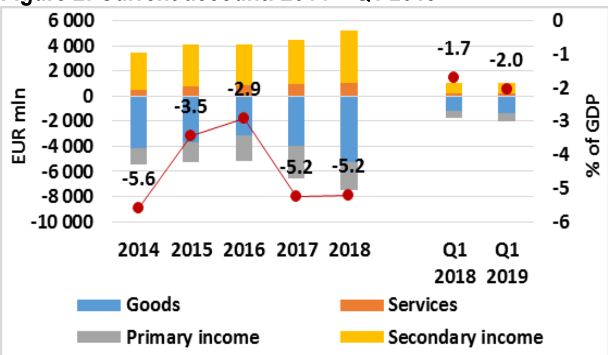
Economic growth notably accelerated from 2% in 2017 to 4.3% in 2018 - the fastest rate in 10 years. Sustained increases in employment and salaries translated into 3.3% higher household consumption expenditure. Investment activity strengthened further, as gross fixed capital formation expanded by 9.2% in 2018, benefiting from the low-interest rate environment and increased public capital spending. Country's exports picked up by 8.3% in real terms, while stronger domestic demand triggered a double-digit growth of 11.1% in imports. Thus, net exports generated a negative impact on the overall GDP growth in 2018.

Economic activity slowed to 2.5% during the first quarter of 2019 reflecting mainly weaker investment performance. In particular, inventories (which had a large positive contribution to GDP growth in 2018) dragged down the growth rate in the first quarter of 2019. Nonetheless, both consumption and fixed investment remained robust, increasing by 3.2% and 8.4%, respectively. Exports growth accelerated to 9.3%, but imports recorded a somewhat more dynamic growth of 9.4%.

Observed from the production side, annual growth in the first three months of 2019 was driven by services and construction sector. Services, which provided 63% of gross value added in Q1, expanded by 3.6% compared to the same prior-year period, whereas the greatest contribution came from trade. After a strong growth of 12.7% in 2018, positive developments in the construction sector continued in the first quarter of 2019. Activity in construction rose by 12.3% in real terms, reflecting the new investment cycle and the implementation of large infrastructure projects. The performance of the agriculture sector remained volatile, recording a negative growth of 3.1%, due to the high base in 2018. Industry also had a negative contribution to the annual GDP growth in the first quarter of 2019, as the industrial production shrank by 3.1% in real terms.

The **trade openness** of the Serbian economy rose from 107.7% in 2017 to 110.2% in 2018 as both imports and exports maintained strong growth. The EU is Serbia's biggest trade partner, accounting for 67% of total exports and 71.2% of total imports in 2018. As a member of CEFTA, 17.4% of Serbian exports in 2018 were absorbed by other CEFTA-member countries, among which Bosnia and Herzegovina and Montenegro have largest contribution. In late 2018, however, Kosovo unilaterally violated this trade agreement by imposing a 100% tariff on imports from Serbia and Bosnia and Herzegovina, which resulted in increased tensions in the region and brought uncertainty for the subsequent economic effects.

Figure 2: Current account: 2014 – Q1 2019



Source: NBS

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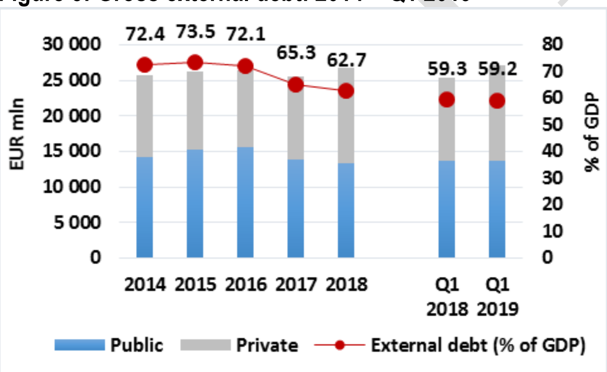
Driven by a deteriorating trade balance, Serbia's **current account** deficit widened from 2.9% of GDP in 2016 to 5.2% of GDP in both 2017 and 2018. The merchandise trade deficit expanded further to 12.3% of GDP in 2018 (from 10.2% in 2017) due to strong imports growth and worse terms of trade. However, the current account deficit in 2018 remained unchanged at 5.2% of GDP as it was compensated by the increased surplus on the net services trade, lower investment income outflows and higher secondary income surplus.

In the first quarter of 2019, current account deficit rose to EUR 937 mln (2% of the projected GDP) from EUR 724 mln (1.7% of GDP) in the same prior-year period. Trade deficit grew annually by 16.3% to EUR 1 324 mln. At the same time, services recorded a surplus of EUR 230 mln. Along with the rising stock of foreign investment, primary income deficit increased by 4.9% y-o-y to EUR 653 mln, while secondary income surplus remained unchanged at EUR 810 mln.

The current account deficit is fully financed by nondebt-generating instruments, as the country has benefited from steady **FDI** inflows. Net FDI inflows in the last 4 years amounted to more than 5% of GDP per year, peaking up to 7.5% of GDP in 2018. In the first quarter of 2019, net FDI inflow increased further - by 10.1% over last year's high base. Foreign investments are well diversified by region of origin as well as 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: 2014 – Q1 2019

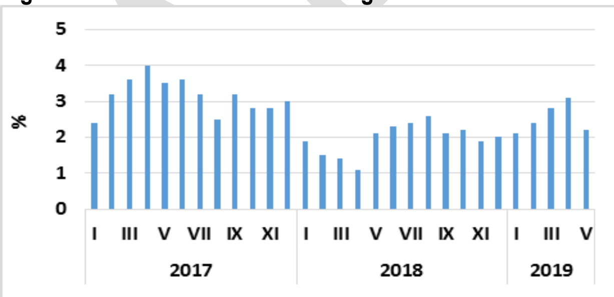


Source: NBS

Starting from 2016, **external debt** to GDP ratio continuously improved. Gross external debt at the end of March 2019 amounted to EUR 27 138 mln (59.2% of the projected GDP), which is a nominal increase of EUR 302 mln compared to the end of 2018. The increase was prompted by the public debt which picked up by EUR 304 mln to 50.6% of total debt, while private external debt decreased by EUR 3 mln. In terms of remaining maturity, the relative share of short-term in total external debt equalled 18.4%, up by 3.2 pp. from end-2018.

International reserves remain adequate**.** At the end of March 2019, NBS foreign exchange reserves stood at EUR 11 440 mln, increasing by EUR 1 205 mln compared to the same period of 2018. This level of reserves ensured coverage of 5.3 months' worth of the country's imports of goods and services. The reserve coverage of the short-term external debt also remained high at 265.1%, thus, reducing the risk of inability to respond to unexpected events occurring on international markets.

Figure 4: CPI – annual rate of change: 2017 – V 2019



Source: SORS

Average annual CPI **inflation** decelerated from 3.2% in 2017 to 2.0% in 2018, on account of subdued imported and domestic price pressures. Inflation in the first half of 2019 edged up slightly, mainly led by food prices, but continued to move in the lower half of the NBS target tolerance band (3% ± 1.5 pp.). The global food and oil price fluctuations would continue influencing short-term price dynamics, while the demand-driven pressures are expected to be largely contained.

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

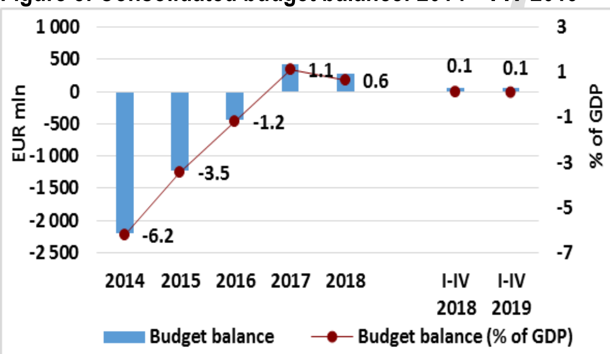
Growing economy and strong FDI supported the favourable development viewed in **labour market** indicators for 2018 and Q1 2019. The unemployment rate lowered from 14.8% as of Q1 2018 to the level of 12.1% although remaining high. The rise in the labour force also benefitted by additional employment gains.

A number of regulation changes aimed at easing labour market functioning have become effective since 2019. The unemployment insurance contributions paid by employers are cancelled, thus, reducing the wage burden. An action plan on the updated National Program for Countering Shadow Economy for the period 2019-2020 was adopted in April 2019 to further clear results at the market. In the first quarter of 2019, undeclared activities employed 17.1% of total employment (18.6% as of Q1 2018).

Income growth accelerated in the beginning of 2019, supported also by public sector and minimum wage hikes. Net monthly wage increased by 9.5% on average compared to Q1 2018. *Information and communication* made the biggest growth thus becoming the sector with the highest paid workers outpacing those in *Financial and insurance activities.*

However, **GDP per capita** in Serbia (EUR 6 100 in 2018) is much lower than the EU-average (EUR 30 900 in 2018) 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: 2014 – I-IV 2019



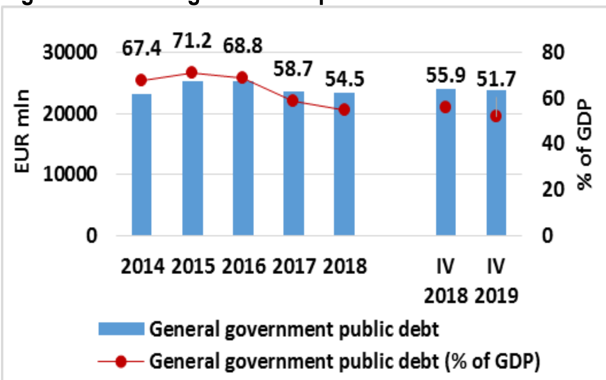
Source: Ministry of Finance

The important **fiscal consolidation** objectives have been achieved faster than planned. The **budget** deficit dropped from 6.6% of GDP in 2014 to 1.2% of GDP in 2016 and turned into a surplus in the last two years - 1.1% and 0.6% of GDP in 2017 and 2018 respectively. Fiscal result in 2018 was by 1.2 pp. of GDP better than planned deficit (-0.6% of GDP). Fiscal overperformance was primarily a result of stronger tax revenue collection, reflecting the favourable macroeconomic trends. At the same time, expenditures were revised upwards, but with significant positive changes in structure. Capital expenditure grew by 48.9% annually to a peak of 3.9% of GDP in 2018, while interest payments performed below the plan

Strong fiscal performance continued over the first months of 2019. In the period January-April 2019, total budget revenue and total budget expenditure both expanded by 10.5% on an annual basis. Backed by robust domestic demand and positive labour market trends, tax revenues grew by 9.4%, with the largest contribution coming from 11.5% higher VAT payments, 8.4% higher social contributions and 38% higher collections from corporate tax. Expenditure growth in the first four months of 2019 was mainly a result of higher pensions and public investments. Current spending increased by 9.1%, while capital expenditures expanded by 43.6% compared to the same period of 2018.

Serbia's budget was in surplus of EUR 66 mln in the first four months of 2019, compared to a surplus of EUR 59 million in the prior-year period. The budget plan for 2019 envisages a consolidated deficit in the amount of 0.5% of GDP, which is also the medium-term deficit target, according to the fiscal strategy for the period 2019-2021. The prudent fiscal stance in the previous years has enabled a moderate policy easing. The fiscal space will be used for increasing public investment, abandonment of crisis measures related to pensions and public sector wages and reducing, albeit only marginally, the tax wedge. These measures are expected to enhance the economic growth potential without jeopardizing public debt reduction.

Figure 6: General government public debt: 2014 – IV 2019



Source: Ministry of Finance

Serbia's **public debt** ratio has been decreasing strongly since 2016. Government debt fell from its peak of 71.2% of GDP in 2015 to 54.5% of GDP in 2018 due to the significant improvements in the budget balance and large debt repayments. Economic growth, which accelerated notably in 2018, also contributed to the fall in the debt ratio. At

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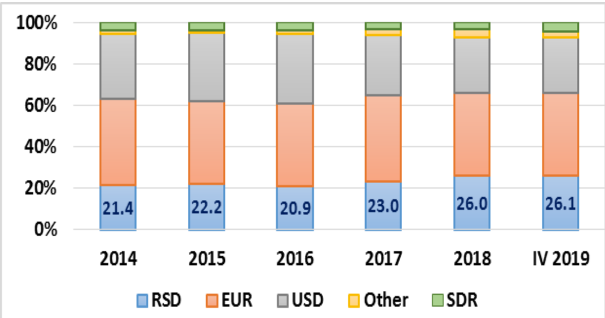
the end of April 2019, total public debt of general government level amounted to EUR 23 769 mln or 51.7% of projected GDP. The small budget deficit is forecast to be instrumental in driving government debt further down, below 50% of GDP in 2020.

Figure 7: Currency structure of central government debt: 2014 – IV 2019



Source: Ministry of Finance

The debt structure has also improved in many aspects. The share of central government debt denominated in national currency picked up from 20.9% in 2016 to 26.1% in April 2019 due to Eurobond repayments as well as greater reliance on dinar-denominated securities. However, the still high share of foreign currency-denominated debt (73.9%) could inflate the public debt level 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 public debt contracted at variable rates (18.9% as of April 2019). In addition, the extension of the average maturity of outstanding debt and lower borrowing costs have somewhat decreased the refinancing risk.

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 to 3.0% in April 2018, and decided to keep it unchanged at this level till the middle of 2019. 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 36.6% and 23.7% for Q1 2019, respectively. Indicators of profitability also retained favourable levels in 2018 in Q1 2019.

Domestic deposit growth remained solid with pronounced preferences towards dinar sight deposits. Foreign liabilities of Serbian banks are maintained at 9-10% of the total liabilities, as over 75% of assets in the system are hold by foreign-owned banks of diversified capital. In line with the enhanced economic activity in 2018 and the beginning of 2019, credit growth of the non-financial sector (NFS) was robust, especially in consumer lending, and the non-performing loans (NPL) have further reduced. As of Q1 2019, the NPL ratio recorded a level of 5.5% (down by 3.7pp. on an annual basis).

The bank receivables and payables of main non-financial sub-sectors preserve their dual currency structure with prevalence of euro over the Serbian dinar. The high euroization remains a challenge for the system as the outstanding euro-indexed loans and deposits contracted in euro hold major part of corporate and households' dealings with banks. Euroization is expected to additionally increment in the segment of mortgage loans applying a law on optional conversion of Housing Loans indexed in Swiss francs into EUR-denominated ones. The law was adopted in April 2019 in order to ease the burden of such debts for their customers. At the same time, according to the regular reports on dinarisation of Serbian financial system (released by NBS), it saw overall increase in 2018 and some divergence in movements of the observed indicators in Q1 2019.

Outlook:

The **positive outlook** of the Sovereign Rating of the Republic of Serbia reflects BCRA's opinion that the track record of prudent fiscal policy has played a major role in increasing confidence in the economy, thus, supporting growth potential. The country attracts large-scale foreign investments, while the external imbalances remain contained with a comfortable level of foreign exchange reserves. On the other hand, Serbia's credit rating is constrained by its low GDP per capita, institutional weaknesses, unresolved Kosovo conflict and still high, albeit decreasing, public debt burden. The EU accession process and the partnership with the IMF are expected to serve as an anchor for government's reform agenda. However, Serbian economy remains susceptible to spillovers and global market volatility

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

- Implementation of important structural reforms, raising the country's growth potential;

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- Stronger than anticipated fiscal results, further lowering the public debt to GDP ratio;
- Sustained 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.

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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 until July 2019, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On July 5, 2019, the 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 included: 1) macroeconomic stability and growth potential; 2) institutional and business environment; 3) good fiscal results 4) current account deficit and its funding sources; 5) external debt structure and international reserves adequacy; 6) banking system developments.

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							
	2019 Q1	2018 Q1	2017	2016	2015	2014	2013
GDP, current prices (EUR millions)	10 171	9 713	42 780	39 183	36 723	35 716	35 467
Final consumption	8 827	8 322	37 145	34 089	31 913	31 578	32 472
Gross fixed capital formation	1 876	1 671	7 980	6 953	6 224	5 989	5 657
Inventories	418	498	1 234	723	352	642	203
Net exports	-949	-779	-3 578	-2 583	-1 766	-2 493	-2 864
Exports of goods and services	5 496	4 982	21 781	19 804	17 853	16 170	14 924
Imports of goods and services	6 446	5 761	25 359	22 386	19 619	18 663	17 788
Real GDP growth (%)	2.5	4.9	4.3	2.0	3.3	1.8	-1.6
Average net monthly wage (EUR)	455	415	420	395	374	368	380
Unemployment rate[1] (%)	12.1	14.8	12.7	13.5	15.3	17.7	19.2
CPI, annual average, last 12 months (%)	2.8	1.4	2.0	3.0	1.6	1.5	1.7
Average exchange rate RSD/EUR	118.23	118.43	118.27	121.34	123.12	120.73	117.31
Average exchange rate RSD/USD	104.05	96.33	100.28	107.50	111.29	108.85	88.54

EXTERNAL SECTOR							
EUR million	2019 Q1	2018 Q1	2017	2016	2015	2014	2013
Current account, net	-937	-724	-2 223	-2 051	-1 075	-1 234	-1 985
Goods	-1 324	-1 138	-5 245	-3 997	-3 119	-3 645	-4 111
Services	230	226	1 092	966	907	729	465
Primary income	-653	-622	-2 207	-2 533	-2 022	-1 658	-1 343
Secondary income	810	810	4 137	3 514	3 159	3 340	3 003
Net FDI	797	723	3 188	2 418	1 899	1 804	1 236
Official foreign reserves	11 440	10 235	11 262	9 962	10 205	10 378	9 907
Gross external debt	27 138	25 388	26 836	25 574	26 494	26 234	25 679
International investment position	-38 096	-36 159	-37 335	-35 675	-34 721	-33 926	-32 513
% of GDP[2]							
Current account, net	-2.0	-1.7	-5.2	-5.2	-2.9	-3.5	-5.6
Goods	-2.9	-2.7	-12.3	-10.2	-8.5	-10.2	-11.6
Services	0.5	0.5	2.6	2.5	2.5	2.0	1.3
Primary income	-1.4	-1.5	-5.2	-6.5	-5.5	-4.6	-3.8
Secondary income	1.8	1.9	9.7	9.0	8.6	9.4	8.5
Net FDI	1.7	1.7	7.5	6.2	5.2	5.1	3.5
Official foreign reserves	24.9	23.9	26.3	25.4	27.8	29.1	27.9
Gross external debt	59.2	59.3	62.7	65.3	72.1	73.5	72.4
International investment position	-83.1	-84.5	-87.3	-91.0	-94.5	-95.0	-91.7

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PUBLIC FINANCE							
EUR million	2019 I-IV	2018 I-IV	2017	2016	2015	2014	2013
Consolidated budget revenues	5 994	5 416	17 800	16 264	14 967	14 038	13 816
Consolidated budget expenditures	5 928	5 357	17 528	15 833	15 405	15 273	16 017
Budget balance	66	59	272	431	-439	-1 235	-2 200
Primary budget balance	529	516	1 191	1 430	630	-160	-1 219
General government public debt	23 769	23 938	23 326	23 551	25 188	25 248	23 197
% of GDP[2]							
Consolidated budget revenues	13.1	12.7	41.6	41.5	40.8	39.3	39.0
Consolidated budget expenditures	12.9	12.5	41.0	40.4	41.9	42.8	45.2
Budget balance	0.1	0.1	0.6	1.1	-1.2	-3.5	-6.2
Primary budget balance	1.2	1.2	2.8	3.6	1.7	-0.4	-3.4
General government public debt	51.7	55.9	54.5	58.7	68.8	71.2	67.4

BANKING SYSTEM							
%	2019 Q1	2018 Q1	2018	2017	2016	2015	2014
Total capital adequacy	23.7	22.7	22.3	22.6	21.8	20.9	20.0
Liquid assets to total assets	36.6	35.9	35.7	35.1	38.9	40.5	42.2
Non-performing loans to total loans	5.5	9.2	5.7	9.8	17.0	21.6	21.5
NPL coverage by provisions	61.3	60.8	60.2	58.1	67.8	62.3	54.9
ROA	1.7	2.1	2.2	2.1	0.7	0.3	0.1
ROE	9.7	10.5	11.3	10.5	3.3	1.5	0.6

[1] Unemployment rate of population aged 15 years and over, Labour Force Survey.
[2] The GDP ratios for 2019 are calculated on the basis of GDP amounting to RSD 5 424 000 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*