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Serbia

July 2020

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SOVEREIGN RATING	Initial rating	Review	Review	Review	Review
Date of Rating Committee	31.07.2017	24.01.2018	16.01.2019	09.01.2020	09.07.2020
Date of rating publication	11.08.2017	26.01.2018	18.01.2019	10.01.2020	10.07.2020
Long-term rating	BB- (ns)	BB (ns)	BB (ns)	BB+ (ns)	BB+ (ns)
Outlook	Stable	Stable	Positive	Stable	Stable
Short-term rating	B (ns)	B (ns)	B (ns)	B (ns)	B (ns)

- (ns) – not solicited 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 **confirms** 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.bcra-bg.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 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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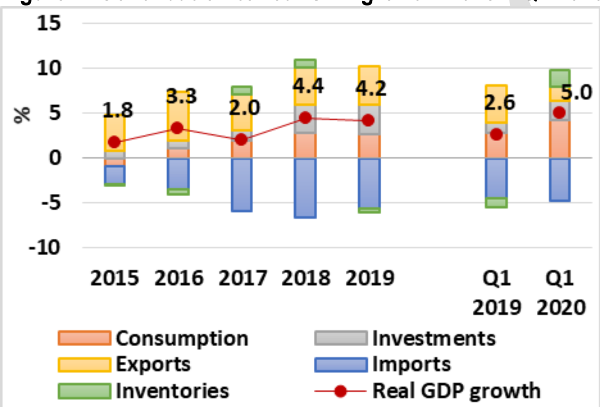
Review report:

Parliamentary and local **elections** were simultaneously held in Serbia on the 21st of June 2020. Initially scheduled for 26 April 2020, they were postponed due to a state of emergency, which lasted from the 15th of March to the 7th of May 2020 declared in response to the COVID-19 pandemic. Main opposition parties boycotted the election on the grounds that government control over the media precluded a free and fair election. The landslide of the ruling Serbian Progressive Party resulted in an absolute parliamentary majority for the next mandate and concreting its leading position. The success doubled according to the results from the local elections, too.

Meanwhile, Kosovo's new government abrogated on the 6th of June 2020 the tariffs on Serbian imports enforced in November 2018. This triggered the option for normalisation of the dialogue between the two parties – a prerequisite for the smooth path of the accession process of Serbia. The **EU accession** is a main strategic goal for Serbia, as the country has opened 18 out of 35 negotiations chapters so far, of which two chapters have been provisionally closed.

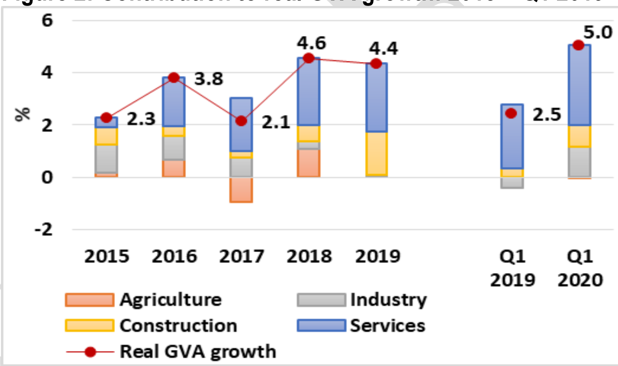
Figure 1: Contribution to real GDP growth: 2015 – Q1 2020



Source: SORS

The COVID-19 outbreak hit the Serbian **economy** just after two years of strong investment-led GDP expansion. Despite the first pandemic effects, real GDP growth accelerated to 5.0% year-on-year in the first quarter of 2020, from 2.6% in the same prior-year period. Economic expansion once again was a result of robust broad-based domestic demand, with negative contribution coming from net exports. Household final consumption annually increased at a sustainable rate of 3.2%, whereas government consumption expenditure grew by 12.0%. Strong investment activity continued in the first months of 2020 as fixed investment picked up by 10.7%, benefiting from low-interest rate environment and large public investment projects. Inventories build-up contributed positively as well. , while the negative contribution of net exports reached 3.3 pp. Real growth rate of Serbian exports markedly decelerated from 8.1% in Q1 2019 to 3.1% in Q1 2020. Concurrently, annual imports dynamic accelerated to 8.3% (from 7.8% in Q1 2019) amid continued investment cycle.

Figure 2: Contribution to real GVA growth: 2015 – Q1 2019



Source: SORS

Observed from the **production side**, annual GVA growth in the first three months of 2020 was driven by positive developments in both industry, construction and services. Aggregate services expanded by 5% compared to the same prior-year period, whereas the greatest contribution came from public services, as well as from information and communication. Gross value added in the construction sector saw a significant real growth of 19.6% reflecting both the private investment activity and the continued implementation of large infrastructure projects. Despite the deceleration of external demand, industrial production annually increased by 4.5% in Q1 2020 as the creation of new production capacities has supported its growth rate. The performance of the agriculture sector remained volatile, recording a negative growth of 0.2%.

Latest Eurostat data shows that Serbia ranks first among the European economies in terms of annual GDP growth in the first quarter of 2020. However, these results have been only moderately impacted by the COVID-19 crisis, as the state of emergency was declared in the second half of March. Thus, the full impact of the lockdown will be reflected in the results for the second quarter.

Although potentially milder than in other European countries, the pandemic will have a significant

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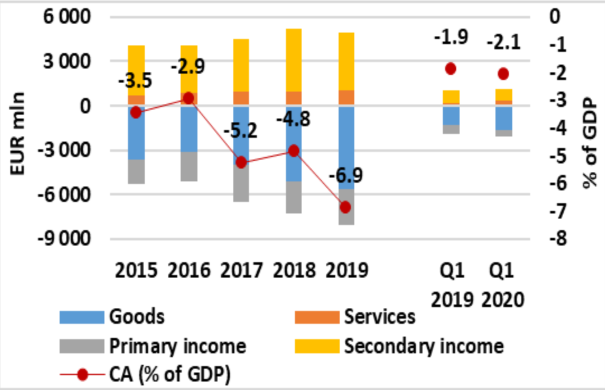
adverse impact on Serbia's economic activity. Private consumption will decline, due to broad lockdown measures, surge in unemployment and fall in household's disposable income. Also, high uncertainty and shrinking demand will weight on both domestic and foreign investment activity, while ongoing projects may be interrupted due to liquidity pressures. Concurrently, exports will decline, reflecting the economic contraction in country's main trading partners and supply chain disruptions. However, the negative contribution of net exports will be limited by the expected reduction in imports.

The European Commission projects[1] that the Serbian economy will contract by 4.1% in 2020, followed by a strong rebound of 6.1% in 2021. However, the recession magnitude and the recovery speed are yet uncertain to predict, as they will be shaped by the pandemic evolution and the timelines of the associated containment in the country, as well as by the dynamics of the recovery in the main trading partners.

Figure 3: Current account: 2015 – Q1 2020

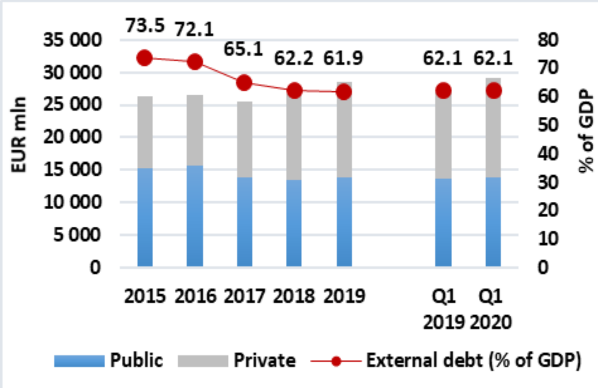


Source: NBS

Serbia's **current account** deficit widened to 6.9% of GDP in 2019, being mainly a result of a higher deficit on trade in goods and a reduction in secondary income surplus. In Q1 2020, the current account deficit continued to widen – to EUR 961 mln, from EUR 819 mln in the same prior-year period. Balance of payments developments in the first three months of 2020 were once again defined by the increase in the trade in goods deficit, which picked up by 27.1% on an annual basis. However, we expect a reduction in the overall current account deficit in 2020 as the coronavirus crisis will result in a sharp decline of domestic demand and imports, and accordingly - a trade balance improvement.

Also, external financing shows a lower reliance on debt-creating inflows as the country has benefited from steady inflows of **foreign direct investment**. Net FDI inflows over the last 5 years averaged to 6.3% of GDP (peaking up to 7.8% of GDP in 2019) and were more than sufficient to cover the negative current account balances. Improvements in the business and investment climate were anticipated in the World Bank's **Doing Business Report** for 2020, in which Serbia has advanced four positions - now ranking 44th out of 190 countries.

Figure 4: Gross external debt: 2015 – Q1 2020



Source: NBS

Gross external debt at the end of March 2020 amounted to EUR 29 034 mln (62.1% of GDP[2]), posting a nominal increase of EUR 616 mln compared to the end of 2019. The increase was prompted by the higher private sector debt, which picked up by a total of EUR 687 mln in the first three months of 2020. Concurrently, public external debt decreased by EUR 71 mln to EUR 13 794 mln (47.5% of total external debt). In terms of remaining maturity, the relative share of short-term debt in total external debt slightly increased to 20.5%, from 19.4% at the end of 2019.

The resilience to external shocks is bolstered by the accumulation of **foreign exchange reserves**, which reached EUR 14 345 mln at the end of May 2020, increasing by EUR 966 mln compared to their end-2019 value. The May increase in foreign reserves was attributable to the inflows from the EUR 2 bln Eurobond issue. The level of reserves is broadly adequate per various metrics, covering about 6 months' worth of country's imports or more than 240% of short-term external debt at remaining maturity.

[1] Spring 2020 Economic Forecast

[2] The GDP ratio is calculated using the sum of GDP for the four preceding quarters.

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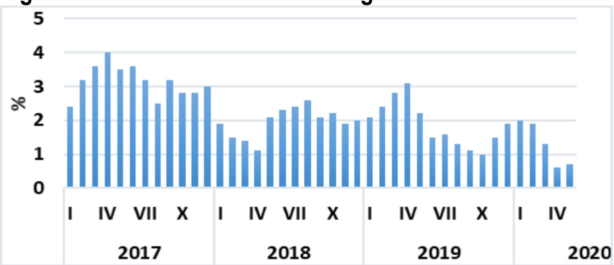
Figure 5: CPI – annual rate of change: 2017– V 2020



Source: SORS

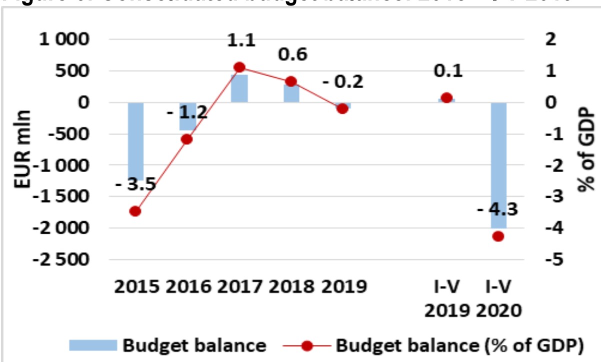
Reflecting the considerable fall in the oil prices and the negative effects of coronavirus on domestic demand, annual **CPI inflation** rapidly decelerated - to 0.7% in May 2019. Inflation is likely to remain below the lower end of the target range (1.5%) in 2020, while rebounding in 2021 due to the recovery. In parallel, the **dinar** remained broadly stable against the euro in H1 2020, despite the heightened uncertainty in the international financial market, while the NBS has continued its practice of intervening in the foreign exchange market to smooth excessive short-term volatility.

Labour market conditions continued to improve in 2019 helped by growing economy and strong FDI. Employment remained on the rise while the unemployment rate reached 10.4% in 2019. The first quarter of 2020 saw satisfactory results as well. The unemployment rate fell to 9.7% while annual employment losses were reported only in the total industry among the broadest economic sectors.

A number of regulation changes aimed at reducing the wage burden; countering shadow economy; addressing high NEET rate as well as public sector and minimum wage hikes have become effective since the beginning of 2019. Their effects are prevented to fully unfold at the current situation of economic restrictions and job losses and are difficult to assess, respectively. The anti-crisis economic policy of the Serbian government implemented new generous income support measures during the lockdown. Health sector wage increase; wage subsidies of the regulatory minimum for all SME employees and entrepreneurs, and of ½ net minimum wage for employees in large private companies and for employees who are currently not working are provided.

Generally, in the first quarter of 2020, net monthly **wages** saw new 10.3% growth in nominal terms after their acceleration by 10.6% in 2019. **GDP per capita** in Serbia (EUR 6 590 in 2019) is, however, much lower than the EU-average (EUR 31 970) and below the measure in neighbouring states like Bulgaria, Romania, and Croatia, which hold the last places among the EU-members. Measured by purchasing power parity, GDP per capita reaches 40.5% of the EU-average as of 2019.

Figure 6: Consolidated budget balance: 2015 – I-V 2019



Source: Ministry of Finance

Prudent **fiscal policy** implemented since 2015 has significantly improved public finance metrics. The budget balance transformed from a deficit of 6.2% of GDP in 2014 to surpluses in 2017 and 2018, while a small deficit of 0.2% of GDP was recorded in 2019. These developments have created an ample fiscal space to cushion the economic and social effects current economic and social effects of the COVID-19 shock.

Faced with this crisis, the government deployed a prompt policy response - a package of measures amounting to about EUR 5.1 bln (11% of GDP) which includes:

- Universal cash transfer of EUR 100 to each citizen over 18 years old;
- Wage subsidies for private sector employees;
- 3-month deferment of labour taxes and social security contributions for all private companies, to be repaid in 24 instalments starting from 2021;
- Deferment corporate income tax advance payment during the second quarter of 2020;
- 10% wage increase for public healthcare sector and increased healthcare spending;
- A state guarantee scheme for bank loans to SMEs;
- Financial support to the corporate sector through the Development Fund.

The package has a direct budgetary impact of around 6% of GDP and another 5% in liquidity-enhancing measures. Its implementation, together with the expected sharp decline in revenues, will

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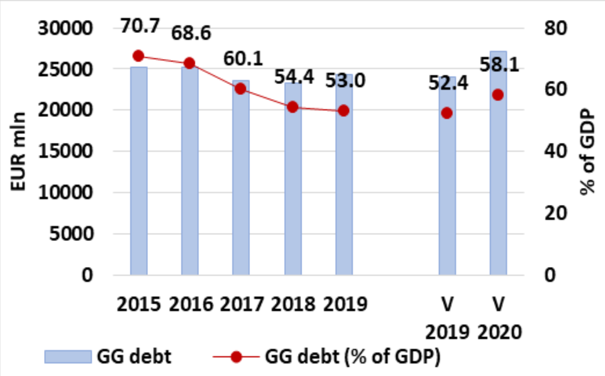
strongly deteriorate the fiscal result in 2020. In January-May 2020, consolidated budget revenues already fell by 6.9% year-on-year, whereas tax revenues declined by 5%, non-tax revenues went down by 22.4%, and grants increased by 32.7%. Concurrently, public expenditure rose by 20.6%, mainly driven by higher subsidies and purchases of goods and services. As a result, general government budget posted a deficit of EUR 2004 mln (4.3% of the projected GDP) in the first five months of 2020. This represents a major slippage compared to the surplus of EUR 55 mln (0.1% of GDP) recorded in the same period of 2019.

Full-year budget deficit in 2020 is now expected to reach around 7% of GDP, while a deficit of 0.5% of GDP was initially projected. We believe that the fiscal slippage is justified and only transitional before the consolidation process resumes back in 2021. However, in case of a steeper decline of economic activity and much slower recovery, public finance deterioration will accelerate and may prove a resistant problem.

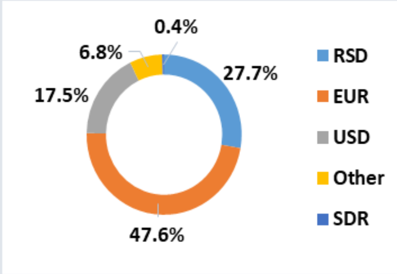
Figure 7: General government public debt: 2015 – V 2020



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 prior to the pandemic. General government debt fell from 70.7% in 2015 to 53% of GDP at the end of 2019, but is now expected to bounce back to around 60% of GDP, due to the heightened financing needs. Stimulus measures would be finance from fiscal reserves, EU and IFIs funding, and additional debt issuance. In May 2020, Serbia successfully raised EUR 2 bln from a seven-year Eurobond issue with a coupon of 3.125%. Overall, general government debt increased by EUR 2 844 mln in the first five months of 2020, reaching EUR 27 198 mln (58.1% of the projected GDP),

Figure 8: Currency structure of Central government debt as of end-May 2020



Source: Ministry of Finance

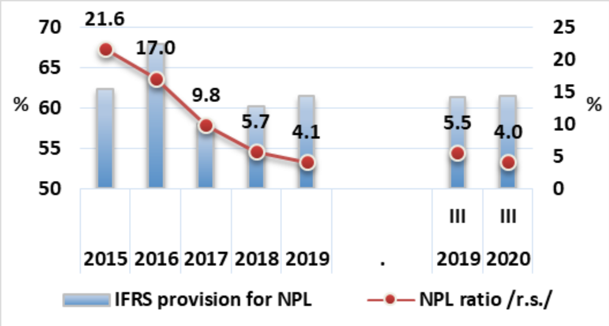
Debt structure has improved in many aspects, thus mitigating the vulnerabilities. The interest rate risk is relatively low, given the small share of public debt contracted at variable rates (14.2%). In addition, the extension of the average maturity of outstanding debt, as well as lower borrowing costs have decreased the refinancing risk. However, the still high share of foreign currency-denominated debt (72.3% of total central government debt) represent a risk as it could inflate the public debt level in case of unfavourable exchange rate movements of the dinar.

The **monetary policy** has proved appropriate in recent years, and it stays so during the current crisis. The NBS cut the key policy rate three times in 2019 to 2.25% by the year's end, and other three times in the first half of 2020 to reach 1.25%. Further monetary easing is designed to mitigate the negative effects of the crisis and support economic recovery while inflationary pressures remain low. Although the system is excessively liquid, the NBS has supplied additional liquidity (dinar and FX) to provide its smooth functioning in any case.

The **banking system** has strengthened its fundamentals and resilience to shocks, respectively. Domestic deposit keeps a steady upward trend proving that the system becomes more trusted. The credit growth of the non-financial sector has also been robust in 2019 and Q1 2020 in line with the economic expansion. The high euroisation of loans has been a challenge, however, and it was additionally boosted in the segment of mortgage loans with the application of the Law on the conversion of housing loans indexed to Swiss francs from May 2019. Concurrently, according to the regular reports on **dinarisation** of the Serbian financial system (released by NBS), the process saw an overall acceleration in Q1 2020.

The law on conversion adopted in April 2019 helped further the progress in the NPL resolution by writing-off a significant portion of former CHF mortgage loans.

Figure 9: NPL and NPL provisions: 2015 – III 2020



Source: National Bank of Serbia

The quality of the banks' portfolio has markedly improved. The NPL ratio shrank to 4.0% as of Q1 2020, down by 1.5pp. on an annual basis and yet beyond comparison with the values recorded in years preceding the NPL Resolution Strategy implementation (exceeding 20% of total gross loans). Having in mind the favourable capital ratios (CAR reaching 22.7% as of end-March 2020) and the generated profitability (ROA of 1.8%; ROE of 10.5%), the system has the resource to withstand the unpreceded economic crisis induced by the COVID-19 spreading and respective lockdown measures. Banks are going to face the consequences from business and individuals hardship and debt payments moratorium on their 2020 performance.

Outlook:

The **stable outlook** of the Sovereign Rating of Serbia reflects BCRA's opinion that currently risks are broadly balanced. The COVID-19 pandemic will have significant adverse impact on economic activity, however, Serbia faces this crisis in a much better position than a decade ago. Track record of prudent policy mix has created fiscal space to cushion the economic and social effects of the pandemic. Fiscal metrics are set to strongly deteriorate this year, but should resume on a downward trajectory in 2021. In addition, the country has benefited from large FDI inflows, while external vulnerabilities are mitigated by a comfortable level of foreign exchange reserves.

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;
- Stronger than anticipated fiscal results;
- Sustained reduction in external imbalances;

Negative pressures on the Sovereign Rating and the Outlook may arise in case of:
- Continued fiscal loosening, leading to a rapid increase of public debt
- Intensification in external imbalances and capital outflows related to sudden shift in investors' sentiment and risk aversion;
- 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 July 2020, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On July 9, 2020, the Rating Committee of BCRA – CREDIT RATING AGENCY (BCRA) had a session, on which the **Report regarding the confirmation 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 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 members of the Committee reviewed the qualitative and quantitative risk factors, taking in account the expected impact of the global coronavirus pandemic. Key points discussed included: 1) domestic politics; 2) macroeconomic fundamentals and growth outlook; 3) external metrics and reserves adequacy; 4) package of economic measures to mitigate the negative effects of the pandemic: 4) public debt sustainability, and 5) banking system developments.

The sovereign ratings and the related outlook have been confirmed 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							
	2020 Q1	2019 Q1	2019	2018	2017	2016	2015
GDP, current prices (EUR millions)	33 406	31 448	45 912	42 855	39 183	36 723	35 716
Final consumption	28 645	26 983	39 111	36 790	34 089	31 913	31 578
Gross fixed capital formation	7 089	6 192	10 299	8 595	6 953	6 224	5 989
Inventories	339	674	519	1 121	723	352	642
Net exports	-2 667	-2 400	-4 017	-3 650	-2 583	-1 766	-2 493
Exports of goods and services	17 602	16 078	23 850	21 760	19 804	17 853	16 170
Imports of goods and services	20 269	18 478	27 867	25 410	22 386	19 619	18 663
Real GDP growth (%)	5.0	2.6	4.2	4.4	2.0	3.3	1.8
Average net monthly wage (EUR)	504	455	466	420	395	374	368
Unemployment rate[1] (%)	9.7	12.1	10.4	12.7	13.5	15.3	17.7
CPI, annual rate of change, period average (%)	1.7	2.4	1.9	2.0	3.2	1.1	1.4
Average exchange rate RSD/EUR	117.57	118.23	117.85	118.27	121.34	123.12	120.73
Average exchange rate RSD/USD	106.61	104.05	105.28	100.28	107.50	111.29	108.85

EXTERNAL SECTOR							
EUR million	2020 Q1	2019 Q1	2019	2018	2017	2016	2015
Current account, net	-961	-819	-3 160	-2 076	-2 051	-1 075	-1 234
Goods	-1 614	-1 270	-5 616	-5 085	-3 997	-3 119	-3 645
Services	319	204	1 049	995	966	907	729
Primary income	-457	-625	-2 477	-2 182	-2 533	-2 022	-1 658
Secondary income	791	872	3 884	4 197	3 514	3 159	3 340
Net FDI	817	792	3 583	3 157	2 418	1 899	1 804
Official foreign reserves	13 115	11 440	13 378	11 262	9 962	10 205	10 378
Gross external debt	29 034	26 913	28 418	26 662	25 526	26 494	26 234
International investment position	-41 630		-40 599	-37 570	-35 579	-34 672	-33 877
% of GDP[2]							
Current account, net	-2.1	-1.9	-6.9	-4.8	-5.2	-2.9	-3.5
Goods	-3.5	-2.9	-12.2	-11.9	-10.2	-8.5	-10.2
Services	0.7	0.5	2.3	2.3	2.5	2.5	2.0
Primary income	-1.0	-1.4	-5.4	-5.1	-6.5	-5.5	-4.6
Secondary income	1.7	2.0	8.5	9.8	9.0	8.6	9.4
Net FDI	1.7	1.8	7.8	7.4	6.2	5.2	5.1
Official foreign reserves	28.1	26.4	29.1	26.3	25.4	27.8	29.1
Gross external debt	62.1	62.1	61.9	62.2	65.1	72.1	73.5
International investment position	-89.1		-88.4	-87.7	-90.8	-94.4	-94.9

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PUBLIC FINANCE							
EUR million	**2020 V**	**2019 V**	**2019**	**2018**	**2017**	**2016**	**2015**
Consolidated public revenues	7 020	7 501	19 334	17 800	16 264	14 967	14 038
Consolidated public expenditures	9 024	7 447	19 428	17 528	15 833	15 405	15 273
Budget balance	-2 004	55	-94	272	431	-439	-1 235
Primary budget balance	-1 521	541	830	1 191	1 430	630	-160
Central government debt	26 791	23 745	23 944	23 015	23 222	24 820	24 819
Internal debt	10 938	9 757	9 993	9 568	9 298	9 149	9 659
External debt	15 852	13 987	13 951	13 446	13 923	15 671	15 160
Gentral government debt	27 198	24 079	24 355	23 328	23 551	25 188	25 248
% of GDP[3]							
Consolidated public revenues	15.0	16.4	42.1	41.5	41.5	40.8	39.3
Consolidated public expenditures	19.3	16.3	42.3	40.9	40.4	41.9	42.8
Budget balance	-4.3	0.1	-0.2	0.6	1.1	-1.2	-3.5
Primary budget balance	-3.2	1.2	1.8	2.8	3.6	1.7	-0.4
Central government debt	57.2	51.7	52.2	53.7	59.3	67.6	69.5
Internal debt	23.4	21.3	19.4	19.5	19.4	23.7	24.9
External debt	33.8	30.5	27.1	27.4	29.0	40.6	39.1
Gentral government debt	58.1	52.4	53.0	54.4	60.1	68.6	70.7

BANKING SYSTEM							
%	**2020 Q1**	**2019 Q1**	**2019**	**2018**	**2017**	**2016**	**2015**
Total capital adequacy	22.7	23.7	23.4	22.3	22.6	21.8	20.9
Liquid assets to total assets	35.9	36.6	36.0	35.7	35.1	38.9	40.5
Non-performing loans to total loans	4.0	5.5	4.1	5.7	9.8	17.0	21.6
NPL coverage by provisions	61.4	61.3	61.5	60.2	58.1	67.8	62.3
ROA	1.8	1.7	1.8	2.2	2.1	0.7	0.3
ROE	10.5	9.7	9.8	11.3	10.5	3.3	1.5

[1] Unemployment rate of population aged 15 years and over, Labour Force Survey.
[2] The GDP ratios for Q1 2019 and Q1 2020 are calculated using the sum of GDP for the four preceding quarters
[2] The GDP ratios for 2020 are calculated on the basis of GDP amounting to RSD 5 507 600 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*