BULGARIA
95, Evlogi Georgiev blvd.
1142 Sofia
Tel. (+359 2) 9876363
www.bcra-bg.com

Serbia

July 2021

Kalina Dimitrova, Lead Economic Analyst
k.dimitrova@bcra-bg.com

Radostina Stamenova, Economic Analyst
stamenova@bcra-bg.com

SOVEREIGN RATING	Initial rating	Review	Review
Date of Rating Committee	31.07.2017	06.01.2021	01.07.2021
Date of rating publication	11.08.2017	08.01.2021	02.07.2021
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*

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.*

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 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)

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

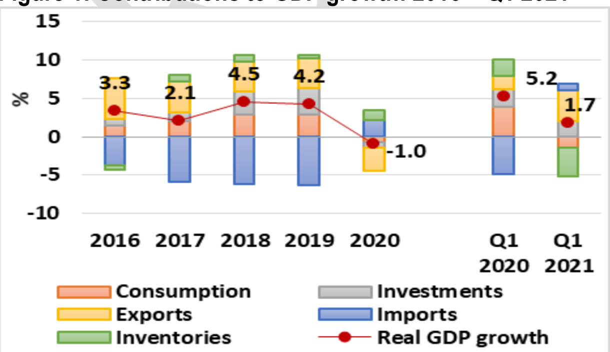
Review report:

The EU accession is a main strategic goal for Serbia, as the country has opened 18 out of 35 negotiation chapters so far, of which two chapters have been provisionally closed. This process has been at a standstill over the last year, including as it regards the normalisation of the dialogue between Serbia and Kosovo - a prerequisite for the smooth path of the accession process of Serbia. Meanwhile, a revised methodology to the negotiations was agreed to apply. Regarding structural issues, the IMF approved to Serbia a new Policy Coordination Instrument of an advisory nature in June 2021. The new 30-month cooperation programme builds on the previous one and is aimed at supporting Serbia's faster economic recovery from the effects of the pandemic, preservation of macroeconomic and financial stability, implementing an ambitious plan of structural reforms to encourage economic growth.

Parliamentary election from June 2020 was boycotted by the main opposition parties 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 and concreting its leading position. Continuity has been observed regarding the policy measures in response to the COVID-19 outbreak, which have been numerous and various.

The very tight restrictions imposed during the second and the third waves of infection (November 2020 – March 2021) have been gradually lifting from the beginning of April 2021. A remarkable advance in initiating the vaccination campaign in Serbia backed by a wide range of immunisation preparations was achieved. At a later stage, financial stimuli were offered to those people who have been hesitating to become vaccinated.

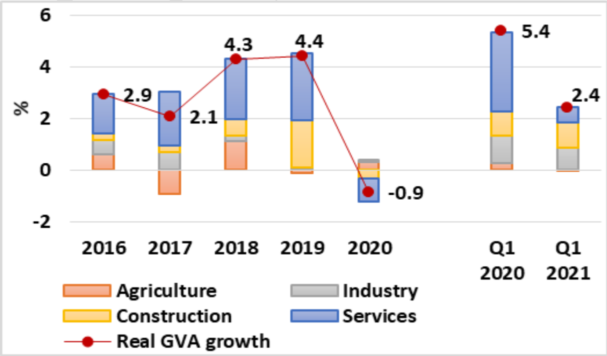
Figure 1: Contributions to GDP growth: 2016 – Q1 2021



Source: SORS

The Serbian **economy** contracted by a relatively mild rate of 1% in 2020 - one of the smallest in Europe, and the recovery is already gaining strength, despite the new pandemic waves. In Q1 2021, real GDP rose by 1.7% against the same prior-year period, driven by the positive contribution of net exports and strong investment activity. The final consumption of households decreased by 1.9% YoY, still being affected by lockdown restrictions. Concurrently, investment activity revived for the first time since the pandemic outbreak. Supported by large public capital spending and reduced uncertainty in doing business, gross fixed capital formation annually expanded by 10% but inventories dragged down the GDP growth. Serbian exports also recovered, increasing by 7.9% in real terms, while imports of goods and services fell by 1.4% YoY, thus, net exports provided the strongest push to GDP growth.

Figure 2: Contributions to GVA growth: 2016 – Q1 2021



Source: SORS

Observed from the **production side**, gross value added (GVA) picked up by 2.4% in the first quarter of 2021 (-0.9% in 2020). The expansion was led by construction and industrial activity, which expanded by 19.5% and 3.5%, respectively. Despite the containment measures brought about by the new wave of the pandemic, the services sector also recorded a positive contribution to overall GVA growth in the first months of 2021 due to developments in trade, ICT, and financial services.

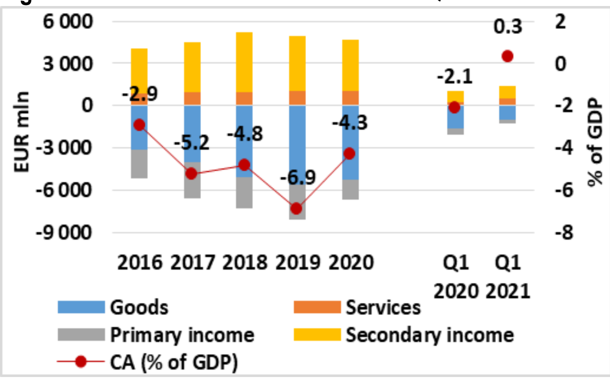
After a much milder than expected contraction in 2020, the Serbian economy is projected to rebound strongly by 5.3% in 2021, according to the EC[1]. The recovery will receive backing from continued monetary easing and targeted fiscal support, however, downside risks associated with the pandemic evolution are still present.

[1] European Commission, Spring 2021 Economic Forecast.

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

Figure 3: Current account deficit: 2016 – Q1 2021

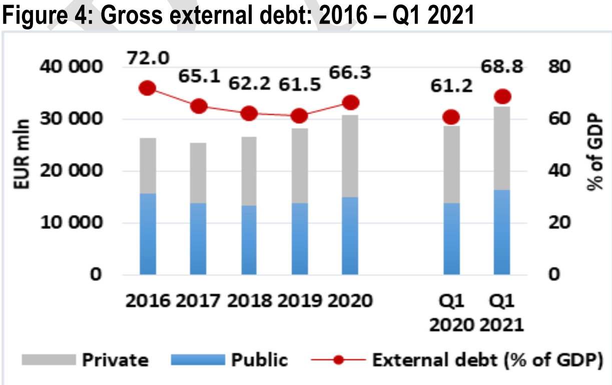


Source: NBS

Serbia's **current account** deficit decreased from 6.9% of GDP in 2019 to 4.3% of GDP in 2020. The improvement mainly reflected the large reduction of the primary income deficit, which fell by 43.4% YoY due to lower profits earned by foreign companies during 2020. The balance improvement continued in Q1 2021 as the current account even recorded a surplus of EUR 138, compared to a deficit of EUR 980 mln in the same prior-year period. Growth of goods exports recovered at a two-digit rate and imports stagnated, thus, the trade deficit declined by 40.2% YoY in January-March 2021, providing the most substantial impact on improving the current account. In addition, the primary income deficit fell by 39.5%, while surpluses on services and secondary income rose by 70.1% and 12.7%, respectively.

Over the past five years, negative current account balances have been more than fully financed from steady inflows of **foreign direct investment,** which remained very resilient in 2020 at 6.2% of GDP despite the unfavourable global investment sentiments related to the pandemic. In Q1 2021, net FDI inflow continued, annually increasing by 5.6%.

Figure 4: Gross external debt: 2016 – Q1 2021

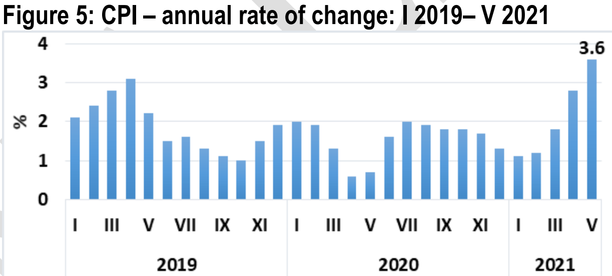


Source: NBS

As of end-March 2021, gross external debt stood at EUR 32 341 mln (68.8% of GDP), compared to EUR 28 655 mln (61.2% of GDP) a year ago. The increase was mainly prompted by the public debt, which reached EUR 16 290 (50.4% of total) but the indebtedness of enterprises and banks also increased. Concurrently, the relative share of short-term debt by remaining maturity decreased to 16.5%.

The resilience to external shocks is secured by an adequate **international reserve** position**.** Eurobond issuances enabled the increase in reserves, which reached EUR 14 276 mln as of end-March 2021 covering 6.6 months' worth of the country's imports or 267.6% of short-term external debt.

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



Source: SORS

After moving around the lower bound of the inflation target band (3% ± 1.5 p.p.) in the first quarter, annual CPI inflation reached 3.6% in May 2021. Inflation is accelerating mostly driven by the rebound of oil prices from their record-low level in 2020 but is expected to remain below 3% in 2021 and 2022.

In parallel, the **dinar** has remained broadly stable against the euro, as the NBS has continued to intervene in the foreign exchange market to smooth the excessive short-term volatility during the crisis period.

The pandemic-induced crisis affected in a limited way the **labour market** outcome in 2020 as the pace of improving market conditions slowed down. The unemployment rate decreased to 9.7% from 11.2% in 2019. The largest employment losses were reported in agriculture and tourism activities while construction had the biggest positive contribution to employment dynamics. During the lockdown in Q1 2021, the unemployment rate recorded 12.8%.

The anti-crisis economic packages of the Serbian government implemented broad-based income support measures counter to the restrictions imposed on economic activity. One-off fiscal

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

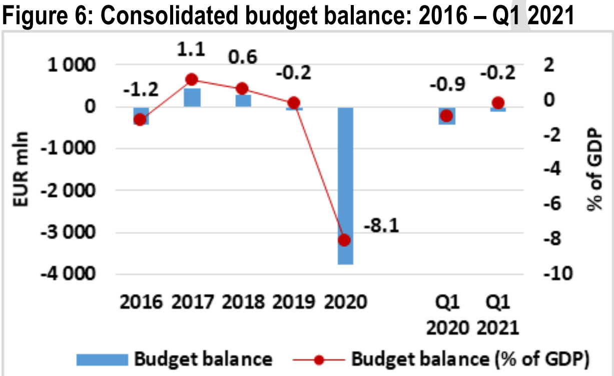
tel.: (+359-2) 987 6363
www.bcra-bg.com

assistance for the most affected sectors - healthcare, transport, tourism and art – have been provided as well as economy-wide wage subsidies for some months in 2020 and 2021, and a one-off payment of EUR 60 to all the unemployed in June 2021. Over 2020, net monthly **wage** saw new 7.7% growth in real terms (after their acceleration by 8.5% in 2019) with no sector recording a decline. The moderate wage rise persisted in the first quarter of 2021 standing at 7.5%.

GDP per capita in Serbia (EUR 6 710 in 2020, EUR 6 620 in 2019) is, however, much lower than the EU-average (EUR 29 730; EUR 32 080 in 2019) and below the measure in neighbouring states like Bulgaria, Romania, and Croatia, which hold the last places among the EU-members.

Prudent **fiscal stance** since 2015 has created ample space to cushion the economic and social effects of the COVID-19 shock. Faced with crisis, the government deployed a prompt response – a large package of support measures in a total amount of about 12% of GDP, which included higher healthcare spending, wage subsidies, deferred tax payments, cash transfers, one-off payments, and state guarantee schemes.

Figure 6: Consolidated budget balance: 2016 – Q1 2021

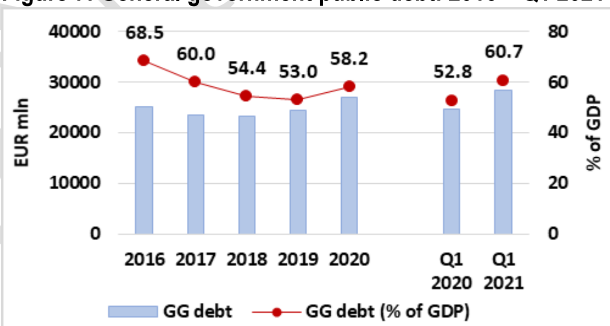


Source: Ministry of Finance

The support expenditures, combined with revenue shortfalls, led to a large deterioration of fiscal result. In 2020, total budget revenues decreased by 0.8% YoY, in which collections from taxes only marginally increased by 0.1%, while non-tax revenues went down by 6.1%. Concurrently, public expenditures rose by 18.1%, mainly driven by higher current spending for subsidies, wages, and purchases of goods and services, but public investment recorded a large increase as well (+10.4% YoY). As a result, the general government budget deficit escalated to EUR 3 766 mln (8.1% of GDP) at the end of 2020, which represented a major slippage compared to the deficit of EUR 94 mln (0.2% of GDP) recorded in 2019.

The 2021 budget bill adopted in December 2020 projected a deficit equivalent to about 3% of GDP but the new waves of the pandemic necessitated greater budgetary support than previously planned, thus a supplementary budget was adopted in April 2021, raising the projected deficit to 7% of GDP. The new fiscal package, amounting to about 4% of GDP, will support the economy in the continued fight against the pandemic by wage subsidies, universal cash transfers, one-off payments to pensioners and unemployed, specific support for the most affected sectors. Also, a large increase in public investment is planned as well as an extension of schemes for state-guaranteed bank loans to SMEs. In line with the expected recovery of economic activity and the expiry of one-off support measures, the medium-term fiscal plan envisages a gradual deficit reduction to 1% of GDP by 2024.

Figure 7: General government public debt: 2016 – Q1 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 53% in 2019, but the large financing needs caused by the pandemic reversed the trend, pushing the general government debt to 58.2% of GDP at the end of 2020. The country has successfully tapped the foreign market, proving that it is enjoying the trust of international investors. In May 2020, the Serbian government raised EUR 2 bln from a seven-year Eurobond, and a ten-year Eurobond worth USD 1.2 bln was issued in November, which enabled early repayment of a significant portion of the more expensive Eurobond from 2011.

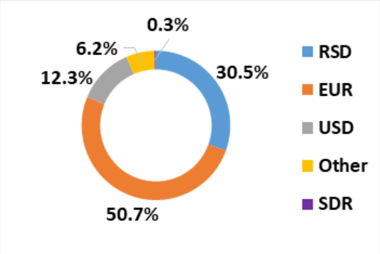
In the first quarter of 2021, the general government debt stock increased by EUR 1 464 mln to EUR 28 520 mln (60.7% of the last 4 quarters' GDP), in which central government debt amounted to EUR

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

28 142, while the relative share of external debt slightly increased to 58.8%, from 57.1% as of end-2020. In February this year, Serbia issued a EUR 1 bln Eurobond with 12-year maturity - the longest period placed on foreign markets so far. Due to the great demand, the yield achieved fell to 1.92%

Figure 8: Currency structure of Central government debt as of end-March 2021



Source: Ministry of Finance

Despite the recent increase, government debt is expected to resume a clear downward trajectory next year, falling to 56% of GDP by the end of 2023 (according to the 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 (12.9%). 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 (69.5% of total central government debt) represents a risk as it could inflate the public debt level in case of unfavourable exchange rate movements of the dinar.

The **monetary policy** has been accommodative and proved appropriate in mitigating the negative effects of the crisis and support economic recovery while inflationary pressures remained low. The NBS kept cutting the key policy rate – from 2.25% by the end of 2019 to 1.00% effective from December 10, 2020. Although the system is excessively liquid, the NBS has supplied additional liquidity (dinar and FX) to provide its smooth functioning and established a precautionary repo line agreement with the ECB for up to EUR 1 billion until end-March 2022.

The lowered price of dinar credit in line with the relaxed credit conditions and reliefs in repayment counter to the crisis gave impetus to lending. The credit growth of the non-financial sector, being robust in 2018-19, accelerated in both segments – households and companies during 2020, and continued in Q1 2021 (by 4.8% and 11.9%, respectively as of March). The loans under the state Guarantee Scheme have largely contributed to that growth and that is why the scheme has been expanded and supplemented in 2021. The NPL ratio shrank to a record low of 3.7% in 2020 (4.1% in 2019), and following the outpacing growth of non-performing loans to total loans reached 3.9% in Q1 2021. It is expected to grow during the year but the maintenance of relatively high coverage by provisions (58.8%) mitigates the ensuing risk.

The banking system has stayed sound in securing financial stability and favourable financing conditions remaining liquid (LCR increased to 239.7% in Q1 2021) and well capitalised (CAR reaching 22.3%), being supported by the steady upward trend in domestic deposit. The profitability indicators - ROA and ROE - decelerated due to the narrowed income to 1.1.% and 6.5%, respectively as of end-2020 (from 1.7% and 9.8% in 2019) and returned upwards in early 2021.

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 support package which prevented a deeper contraction in 2020, while the recovery is already on track. Amid large financing needs the government debt has picked up to about 60% of GDP but is expected to resume a downward trajectory in 2022. In addition, external vulnerabilities are mitigated by a secure level of foreign exchange reserves and resilient FDI inflows, while the banking system remains stable.

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

- Continued fiscal loosening, leading to a rapid increase in public debt;
- Intensification in external imbalances and capital outflows related to a sudden shift in investors' sentiments;
- Diminishing foreign reserve buffer.

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

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 end-June 2021, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On July 1, 2021, 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** 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.

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

Tables:

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

MAIN MACROECONOMIC INDICATORS

	2021 Q1	2020 Q1	2020	2019	2018	2017	2016
GDP, current prices (EUR mln)	11 603	11 086	46 468	45 970	42 892	39 235	36 779
Final consumption	9 593	9 449	39 836	39 019	36 875	34 138	31 905
Gross fixed capital formation	2 512	2 294	9 986	10 334	8 596	6 959	6 274
Inventories	-47	643	782	1 207	1 121	721	375
Net exports	-455	-1 300	-4 137	-4 589	-3 700	-2 584	-1 775
Exports of goods and services	6 227	5 585	22 299	23 468	21 633	19 803	17 844
Imports of goods and services	6 683	6 885	26 436	28 057	25 332	22 386	19 619
Real GDP growth (%)	1.7	5.2	-1.0	4.2	4.5	2.1	3.3
Average net monthly wage (EUR)	504.2	459.4	510.9	466.0	419.8	394.7	374.4
Unemployment rate[1] (%)	12.8	10.5	10	11	14	15	16
GDP per capita[2] (EUR)	-	-	6 710	6 620	6 140	5 590	5 210
CPI annual, period average (%)	1.4	1.7	1.5	1.9	2.0	3.2	1.1
Average exchange rate RSD/EUR	117.58	117.57	117.58	117.85	118.27	121.34	123.12
Average exchange rate RSD/USD	97.52	106.61	103.03	105.28	100.28	107.50	111.29

EXTERNAL SECTOR

EUR mln	2021 Q1	2020 Q1	2020	2019	2018	2017	2016
Current account, net	138	-980	-1 981	-3 161	-2 076	-2 051	-1 075
Goods	-954	-1 595	-5 224	-5 623	-5 085	-3 997	-3 119
Services	477	281	1 075	1 012	995	966	907
Primary income	-277	-457	-1 404	-2 479	-2 182	-2 533	-2 022
Secondary income	891	791	3 572	3 929	4 197	3 514	3 159
Net FDI	842	798	2 902	3 551	3 157	2 418	1 899
Official foreign reserves	14 276	13 115	13 492	13 378	11 262	9 962	10 205
Gross external debt	32 341	28 655	30 813	28 254	26 662	25 526	26 494
International investment position	-42 466		-42 349	-40 478	-37 555	-35 579	-34 672
% of GDP[3]							
Current account, net	0.3	-2.1	-4.3	-6.9	-4.8	-5.2	-2.9
Goods	-2.0	-3.4	-11.2	-12.2	-11.9	-10.2	-8.5
Services	1.0	0.6	2.3	2.2	2.3	2.5	2.5
Primary income	-0.6	-1.0	-3.0	-5.4	-5.1	-6.5	-5.5
Secondary income	1.9	1.7	7.7	8.5	9.8	9.0	8.6
Net FDI	1.8	1.7	6.2	7.7	7.4	6.2	5.2
Official foreign reserves	30.4	28.0	29.0	29.1	26.3	25.4	27.7
Gross external debt	68.8	61.2	66.3	61.5	62.2	65.1	72.0
International investment position	-90.4		-91.1	-88.1	-87.6	-90.7	-94.3

95, Evlogi Georgiev blvd., fl. 1
1142 Sofia

tel.: (+359-2) 987 6363
www.bcra-bg.com

PUBLIC FINANCE							
EUR mln	**2021 Q1**	**2020 Q1**	**2020**	**2019**	**2018**	**2017**	**2016**
Consolidated public revenues	5 056	4 567	19 178	19 334	17 800	16 264	14 967
Consolidated public expenditures	5 164	5 011	22 944	19 428	17 528	15 833	15 405
Budget balance	-108	-444	-3 766	-94	272	431	-439
Primary budget balance	302	-42	-2 828	830	1 191	1 430	630
Central government debt	28 142	24 308	26 669	23 944	23 015	23 222	24 820
Internal debt	11 594	10 457	11 434	9 993	9 568	9 298	9 149
External debt	16 548	13 852	15 235	13 951	13 446	13 923	15 671
Gentral government debt	28 520	24 725	27 056	24 355	23 328	23 551	25 188
% of GDP[3]							
Consolidated public revenues	10.8	9.7	41.3	42.1	41.5	41.5	40.7
Consolidated public expenditures	11.0	10.7	49.4	42.3	40.9	40.4	41.9
Budget balance	-0.2	-0.9	-8.1	-0.2	0.6	1.1	-1.2
Primary budget balance	0.6	-0.1	-6.1	1.8	2.8	3.6	1.7
Central government debt	59.9	51.9	57.4	52.1	53.7	59.2	67.5
Internal debt	24.7	22.3	24.6	21.7	22.3	23.7	24.9
External debt	35.2	29.6	32.8	30.3	31.3	35.5	42.6
Gentral government debt	60.7	52.8	58.2	53.0	54.4	60.0	68.5

BANKING SYSTEM							
%	**2021 Q1**	**2020 Q1**	**2020**	**2019**	**2018**	**2017**	**2016**
Total capital adequacy	22.3	22.7	22.4	23.4	22.3	22.6	21.8
Liquid assets to total assets	37.4	35.9	37.3	36.0	35.7	35.1	38.9
Non-performing loans to total loans	3.9	4.0	3.7	4.1	5.7	9.8	17.0
NPL coverage by provisions	58.8	61.4	59.0	61.5	60.2	58.1	67.8
ROA	1.2	1.8	1.1	1.8	2.2	2.1	0.7
ROE	7.3	10.5	6.5	9.8	11.3	10.5	3.3

[1] Starting from 2021, the Statistical Office of the Republic of Serbia switches to a new, redesigned methodology of the Labour Force Survey (LFS);
[2] Eurostat data;
[3] The GDP ratios for Q1 2021 and Q1 2020 are calculated using the sum of nominal GDP in the four preceding quarters.

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*