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Serbia

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SOVEREIGN RATING	Initial rating
Date of Rating Committee	31.07.2017
Date of rating publication	11.08.2017
Long-term rating	BB- (ns)
Outlook	Stable
Short-term rating	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 stable outlook.

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

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

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Detailed research report (for public disclosure)

The Republic of Serbia became a stand-alone sovereign republic in 2006 as Montenegro voted, after a referendum on independence, to leave the State Union of Serbia and Montenegro.

Albanian ethnic majority representatives in Kosovo, which is an autonomous region of Serbia according to the 2006 Serbian constitution, declared independence on the 17th of February 2008. This act was never officially acknowledged by Serbia and part of the international community. Many countries recognized Kosovo as an independent state, but the government in Belgrade retained a high level of control on the Serbian enclaves. The conflict between Kosovo and Serbia dominates permanently the foreign relations and internal political development of Kosovo since then, but no further escalation is observed.

The Serbian Progressive Party (SNS) dominates the political landscape of Serbia during the last three years (2014 – 2016) sidelining the Democratic Party. Early elections were called in 2014 and 2016 to confirm the electoral support for the SNS and its policy. The results of both elections are identical – the party of A. Vučić (SNS) was supported by about 50 percent of the votes, followed by the Socialist Party of Serbia (SPS) with about 10 to 15 percent of the votes. Both parties were jointly governing the country in this period.

Aleksandar Vučić was elected for president of Serbia on the first round of the presidential elections held in April 2017 with about 55 percent of the votes. A month later he took the office from T. Nikolić. Still prime-minister in 2014 - 2017 Vučić followed policies of accelerated modernization of the economy and preparation for an EU membership.

A government headed by Ana Brnabić, former minister of public administration and local self-government, was elected by the members of the Serbian parliament after A. Vučić was elected for president. Brnabić is considered to have no party affiliation and demonstrates a technocratic style of governing the country.

Serbia is a member of the Council of Europe and, since 2012, the country has become a candidate for membership of the European Union. A factor of importance for continuation of the accession process is the agreement reached in April 2013 (*Brussels Agreement*) on the normalization of Kosovo–Serbia relations, which guarantees the rights of the Serb minority in northern Kosovo and regulates the powers of key institutions in the disputable territories.

Official negotiations on Serbia's accession to the EU are opened in early 2014 as six meetings of the Accession Conference are held by the time of this report. However, there is still no "road map" or a fixed date for achieving the expected membership.

The effects of the global crisis encompass the country in 2009, resulting in a recession of 3.1% in real terms. The growth in the next years is modest and followed by two more recessions in 2012 and 2014, primarily caused by natural disasters. The floods in 2014 inflict significant damage to some key sectors, especially agriculture, mining and electricity supply. The transport infrastructure (roads, bridges and railways in particular) is also greatly damaged. In addition, weak domestic demand and various structural problems deter the economic growth.

Despite the unfavourable developments, Serbian economy is again on the path to recovery. In 2016, GDP increases by 2.8% in real terms – the highest rate reached after the crisis. The growth achieved in the first quarter of 2017 is 1.2%.

As key to economic growth arise the country's exports. Their share in GDP increases notably after the crisis, backed by relatively stable investment inflows and improved competitiveness of the high-value-added export positions (machinery and equipment). Although consumption has been the main contributor to GDP growth in pre-crisis years, its effects afterwards tend to be negligible. Its growth after 2009 is volatile and easily affected by quickly changing economic conditions.

The largest share in the gross value added structure of Serbia is held by the aggregate industry group: *Manufacturing, Mining and Quarrying and Other industry*. The agriculture sector has a considerable share of 8.5%. Construction accounts for barely 5-6% of GVA. Construction sector marks a more convincing improvement in the last two years, supported by changes in the legislative framework and simplification of administrative procedures.

The general contributor for the acceleration in the growth rate of the produced GVA for last year (2016) is the aggregate industry sector. Other sectors with notable contributions in recent years include *Wholesale and retail trade*, *Transportation and storage*, *Accommodations and Food service activities* and *Agriculture, forestry and fishing*.

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Serbia has an economy that is relatively open to the world. The country has been trading actively in recent years as observed in the developments in its Balance of payments and affirmed by the positive dynamics in the open market index.

Serbia trades mainly with EU-member countries. The progress in the convergence of the country to the European Union is accompanied by lowering of barriers to trade in goods. The shares of the EU-members in Serbia's international trade of goods grow further during the whole observed period to 66.1% of all exports and 63.1% of all imports in 2016. Major trade partners among the EU-member countries are Italy and Germany in the lead, followed by Romania, Hungary, Slovenia and Croatia. The direct impact of Brexit on the Serbian economy is expected to be insignificant, considering the small share of UK in the foreign trade of the country. However, the risk is posed by the effects of this process on the economies of the major foreign trade partners of Serbia and by the possibility of their indirect spill over.

Serbia is a member of the Central European Free Trade Agreement (CEFTA) and round 1/5 of Serbian exports of goods are absorbed by CEFTA-member countries, mainly Bosnia and Herzegovina and Montenegro. Other countries with considerable presence in Serbian foreign trade relations are Russia and China.

Exports from Serbia are mainly oriented towards trade with high-value added goods - *Machinery and transport equipment* and *Manufactured goods classified chiefly by material*, indicating the presence of international competitiveness of the country's production. Imported goods also include high-value added articles, which partially counters the positive effects stemming from the exports' characteristics in the goods' trade balance.

The dynamics in international trade are also reflected in the current account balance, which is characterized by a persistent deficit and periods of increase and decrease in its value. In 2016, the current account deficit narrowed to its lowest level – 4.0% of the GDP or EUR 1 370 mln. The groups contributing negatively for the balance are trade in goods and primary income, whereas trade in services and secondary income generate surpluses. Trade balance is gradually improving after the crisis, with exports being stimulated by domestic currency depreciation.

The dynamics in the financial account reflect the higher year-on-year increase in foreign liabilities compared to the growth in Serbian residents' foreign assets. Serbia records stable inflow of foreign direct investments. Broken down by country, the largest part of direct investments comes from the EU Member States (63% of all FDIs inflows in 2016), especially from the Netherlands, Austria, Italy, Germany, France, Greece and Luxemburg. Investment interest from Asia is also obvious as 19% of the FDIs in 2016 originate from Asia, whereas the United Arab Emirates, Hong Kong, China and the Republic of Korea have a major contribution. The Russian Federation is other important investor in Serbia with a constant interest. The distribution of investments in the manufacturing industry provides wide basis for growth of the industrial sector and exports in the coming period.

With respect to the country's labour market, it has recorded some improvements in recent years, bringing down the unemployment rate from 23.9% in 2012 to 15.3% in 2016. However, the indicator remains significantly higher than the EU-average (8.5%). The youth unemployment is also at disadvantageous levels – more than twice as high as the overall unemployment.

The GDP per capita in Serbia is much lower than the EU-average and also below the measure in neighbouring countries like Romania and Bulgaria, which hold the last two places among the EU-members by this indicator.

The inflation decreases gradually after 2013. The decrease reflects the persistently strong disinflationary pressures in the euro area, as well as the implementation of fiscal consolidation measures. There are also effects streaming from the fall in oil prices in the international markets at the end of 2014 and continuing during 2015. In the first quarter of 2017 annual inflation reaches 1.5% on average basis. A more inflationary impact in the period ahead will originate from the gradual increase in domestic demand and the rising inflation in the EU.

After the financial crisis public finance indicators have been showing the emergence and intensification of some problems. They are mostly related to budget deficits stemming from changes in budget categories – faster growth in government expenditures relative to the growth in revenues. The negative developments in the budget balance lead to a notable increase in the country's indebtedness and interest payments. The government therefore undertakes consolidation measures after 2011, with more major changes as of 2012. The measures are aimed mostly at

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enhancing the revenue side, due to numerous changes in different tax rates. However, the floods in 2014 have adverse effect and the budget deficit rises to 6.6%.

In an effort to address the above macroeconomic challenges, in 2015 the government agrees with the IMF on a 3-year Precautionary Stand-by Arrangement. The program seeks to implement ambitious fiscal consolidation and structural reforms to lower public expenditures, halt the rise in public debt and put it on a downward trajectory.

Marked improvement is observed in 2016 as the consolidated general government budget balance shrinks to -1.3% of GDP, whereas Republican budget is almost balanced (at -0.2% of GDP). Fiscal developments reflect positive macroeconomic trends and economic growth acceleration.

Serbia's public debt increases steadily since 2008. The continuous deficits in the budget balance transmit negative effects over the country's indebtedness, as the financing needs accumulate year after year. Central government debt, as a share of GDP, reaches a peak in 2015 standing at 74.7% of GDP (28.3% of GDP in 2008). Improvements to the fiscal framework in Serbia slow down the growth in public debt. Central government debt stands at 67.1%% of GDP (EUR 24 059 mln) at the end of May 2017.

Public debt structure is characterised by prevalence of external over domestic debt. In terms of currency, most of the debt is denominated in EUR (40%), USD (32.8%) and RSD (21.7%). The large amount of debt denominated in foreign currency carries risk due to possible changes in the exchange rates for the dinar – euro and euro - US dollar.

The government securities market has grown significantly over the last 6 years and the maturity of instruments is gradually lengthened. Securities in the public debt portfolio are dinar-denominated securities (Government T-bills and T-bonds), and fixed coupon securities - euro-denominated bonds issued in the domestic market and Eurobonds. The costs of government borrowing mark a falling trend since end-2012, triggered by the global developments in terms of policy relaxation. The drop is also backed by domestic factors – the positive effects of the fiscal consolidation, relatively stable exchange rate and low inflation over the last three years (2014 - 2016).

The gross external debt of the Serbian economy also has been growing steadily after the crisis on account of government borrowing. The share of public external debt in total debt rises from 31% in 2008 to 59% at end-2016. External debt of the private sector marks a minor increase in 2009 but afterwards is constantly shrinking as a result of low economic activity and uncertainty on the part of external investors as well as limited demand for credit.

Gross external debt stands at 73.7% at the end of March 2017, which is below the level indicating high indebtedness (80%) according to the World Bank criteria. Favourable development is observed in terms of remaining maturity, as the share of short-term external debt is decreasing on account of medium and long-term debt.

The level of official foreign exchange reserves ensures 5.7 months coverage over imports, enough adequate to reduces the risk of inability to respond to unexpected events occurring on international markets.

Banking system in Serbia demonstrates uneven performance throughout the analysed period (as does the economy countrywide). Albeit slowly, it moves in the positive direction after 2013 - the only year of pronounced negative dynamics. Two banking institutions are delicensed by the NBS in 2013, which results in restructuring the system as well as in loss in its financial result.

Over the subsequent period: 2014 - Q1 2017, banking system registers moderate assets growth, backed by stable expand in deposit base. So, this prevents from significant rise in market concentration in terms of assets.

Although foreign-owned banks with private capital originating from Italy, Austria, France, and Greece are among the first ten banks by assets, bank capital is related not only to EU parent institutions, but it also represents interests from Russia, Turkey and the USA.

Serbian banking sector is generally characterised by high liquidity and capital adequacy. Regulations by Basel III framework are gradually implemented in local legislation making it more compatible with peer economies and adequate to the whole financial sector needs.

While loans granted to the corporate sector exhibit more volatile movement, the sector of households marks enhanced credit activity. In terms of the currency structure of banking operations a process of dinarisation is present both in deposits and lending in consistency with respective NBS strategy. The currency with dominant share, however, remains the euro holding over 60% in both total gross lending and deposits

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of non-financial sector. This strengthen the capital position of the local banking system and shows increasing in confidence to it.

Major challenges it faces include the sizeable share of non-performing exposure in total gross loans (although fully provisioned), the still low profitability, and the exposure to contagion risks related to the prevalence of foreign capital.

Outlook:

The stable outlook of the Sovereign Rating of the Republic of Serbia reflects the BCRA's opinion that the risks to the country's development are balanced and they currently do not affect their creditworthiness. Economic growth is expected to be supported by the continued progress with the European Union accession process. BCRA do not expect any drastic changes in the political situation to happen in short and medium term. We believe that the government's commitment to fiscal consolidation would go further.

BCRA would consider upgrading the Sovereign Rating and the Outlook for the Republic of Serbia if the country continues to record stable positive dynamics in key economic indicators, namely high GDP growth, strengthening of trade and international relations, improving trade balances and labour market conditions, effective management of public debt, complemented by stable and developing financial sector.

Negative pressures on the Sovereign Rating and the Outlook would be considered to be deterioration in the external and fiscal indicators. Additional factors will be considered slow-down in economic growth and possible problems stemming from the banking system (including spill-over effects).

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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 June 2017, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On the 31th of July 2017 Rating Committee of BCRA – CREDIT RATING AGENCY (BCRA) had a session, on which the **Report regarding the issuing of an unsolicited initial sovereign rating of Serbia** was discussed**.**

The members of the Rating Committee discussed the grades of numerous credit rating factors included in the **Model for grading** and analysed in the **Credit Rating Report** according to the **Sovereign Rating Methodology**.

The members of the committee considered the main characteristics of the political environment focusing on the process of EU integration of the country. The government collaboration with the IMF, designed to restore sustainable economic growth through reforms in the fiscal sector, was viewed favourably.

In detail were discussed the volatile trends in a number of key macroeconomic indicators, like the economic growth, its components and incomes. It was commented that the labour market conditions, expressed by the unemployment rate, as well as the external imbalances rise concerns about structural problems in the analysed economy.

The long-term investors' interest in the country was viewed positively and so was did the moderate inflation since 2014 and the development potential of banking system (backed by favourable levels in its qualitative ratios). Additional attention was drawn to the dynamics in the exchange rate (of the RSD to the EUR and USD) and the changes in the price level in the last few years.

The members discussed in detail the developments in the country's public finances and the dynamics in their sub-categories. The fiscal consolidation in recent years has managed to narrow the budget deficit and the public debt, which decreases the risk concerning debt payments in the short and medium term.

The current initial sovereign rating and the related outlook have been determined based on the above discussion.

Tables

Country	*Development classification*	*Probability of default indicator*
Republic of Serbia	*Emerging and Developing Europe (IMF classification)*	*N/A*

General economy

Indicators	2017 Q1	2016 Q1	2016	2015	2014	2013	2012	2011	2010	2009	2008
GDP (in billion RSD)	974	936	4 200	4 043	3 908	3 876	3 584	3 408	3 067	2 880	2 745
GDP (in billion EUR[1])	7,86	7,62	34,12	33,49	33,32	34,26	31,68	33,42	29,77	30,65	33,70
Final consumption expenditure	7,53	7,29	30,45	30,44	31,10	31,88	30,31	31,85	28,73	29,58	31,91
Household final consumption	*6,17*	*5,97*	*24,61*	*24,70*	*24,91*	*25,50*	*24,11*	*25,47*	*22,96*	*23,53*	*25,03*
NPISH final consumption	*0,08*	*0,07*	*0,31*	*0,31*	*0,29*	*0,29*	*0,31*	*0,31*	*0,27*	*0,27*	*0,33*
Government final consumption	*1,28*	*1,24*	*5,53*	*5,43*	*5,91*	*6,09*	*5,88*	*6,08*	*5,50*	*5,77*	*6,56*
Gross fixed capital formation	1,37	1,32	6,08	5,93	5,56	5,91	6,71	6,15	5,53	6,03	8,40
Change in inventories	*-0,25*	*-0,43*	*0,08*	*0,39*	*0,27*	*0,14*	*-0,05*	*0,57*	*-0,03*	*-0,07*	*1,82*
Net exports of G&S	*-0,78*	*-0,55*	*-2,50*	*-3,27*	*-3,61*	*-3,67*	*-5,28*	*-5,15*	*-4,46*	*-4,87*	*-8,43*
Exports of G&S	*4,35*	*3,96*	*17,37*	*15,63*	*14,45*	*14,12*	*11,70*	*11,36*	*9,80*	*8,23*	*9,81*
Imports of G&S	5,14	4,51	19,87	18,90	18,07	17,79	16,98	16,50	14,26	13,10	18,25
GDP (annual growth rate; in %)	1,2	3,8	2,8	0,8	-1,8	2,6	-1,0	1,4	0,6	-3,1	5,4
GDP per capita (EUR; current prices)	-	-	-	4720	4672	4781	4400	4619	4082	4187	4586
Total average net monthly wage (EUR)	367	355	343	374	368	380	388	366	372	331	338
Annual average inflation rate (CPI; %)	1,5	1,5	1,1	1,4	2,1	7,9	7,3	11,2	6,1	8,1	12,5
Annal inflation rate, end of period (CPI; %)	3,6	0,6	1,6	1,5	1,7	2,2	12,2	7,0	10,2	6,6	8,6
Unemployment rate (in %, population 15+)	14,6	19,0	15,3	17,7	19,2	22,1	23,9	23,0	19,2	16,1	13,6
Average exchange rate RSD/EUR	123,88	122,85	123,12	120,73	117,31	113,14	113,13	101,95	103,04	93,95	81,44
Average exchange rate RSD/USD	116,19	111,42	111,29	108,85	88,54	85,17	88,12	73,34	77,91	67,47	55,76

Balance of payments

(in million EUR)	2017 Q1	2016 Q1	2016	2015	2014	2013	2012	2011	2010	2009	2008
Net export of goods and services	-785	-553	-2501	-3266	-3614	-3669	-5281	-5146	-4462	-4874	-8434
Current account	-742	-378	-1370	-1577	-1985	-2098	-3671	-3656	-2037	-2032	-7126
as % of GDP	*-9,44*	*-4,97*	*-4,02*	*-4,71*	*-5,96*	*-6,12*	*-11,59*	*-10,94*	*-6,84*	*-6,63*	*-21,14*
Credit	5302	4862	21581	20107	18493	18081	15426	15060	13567	12277	12962
Debit	6044	5240	22952	21685	20478	20180	19098	18716	15604	14308	20088
Goods and services	*-803*	*-563*	*-2581*	*-3268*	*-3645*	*-3845*	*-5523*	*-5341*	*-4729*	*-5056*	*-8684*
Goods	-1022	-745	-3476	-3993	-4111	-4159	-5634	-5496	-4719	-5066	-8488

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Services		219	182	895	725	465	313	111	154	-10	9	-196
Primary income		*-652*	*-486*	*-1950*	*-1658*	*-1343*	*-1419*	*-1097*	*-1368*	*-658*	*-479*	*-983*
Secondary income		*713*	*670*	*3161*	*3349*	*3003*	*3166*	*2949*	*3054*	*3351*	*3504*	*2541*
Capital account		*1*	*5*	*-10*	*-18*	*7*	*15*	*-8*	*-3*	*0*	*0*	*6*
Financial account		*-521*	*-184*	*-790*	*-1205*	*-1705*	*-1630*	*-3351*	*-3340*	*-1553*	*-2280*	*-6598*
Public finance												
		2017	**2016**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**
	in billion EUR [1]	**I -V**	**I -V**									
Republican budget	Revenues	3,51	3,28	8,46	7,85	7,51	7,18	6,97	7,31	6,91	6,98	8,00
	Expenditures	3,41	3,38	8,53	8,80	9,62	8,95	8,85	8,64	7,91	7,97	8,58
	Surplus | Deficit	0,10	-0,09	-0,06	-0,95	-2,10	-1,78	-1,88	-1,33	-1,00	-0,99	-0,58
	Balance (% of GDP)	0,28	-0,27	-0,19	-2,84	-6,32	-5,18	-5,95	-3,99	-3,36	-3,22	-1,73
Consolidated general government budget	Revenues	5,40	5,01	12,88	12,12	12,27	12,08	13,01	13,37	12,41	12,78	14,65
	Expenditures	6,01	6,02	15,41	15,27	16,02	15,47	15,18	14,97	13,78	14,13	15,54
	Surplus | Deficit	0,19	-0,20	-0,44	-1,24	-2,20	-1,87	-2,17	-1,60	-1,37	-1,35	-0,88
	Balance (% of GDP)	0,52	-0,59	-1,29	-3,69	-6,60	-5,47	-6,84	-4,80	-4,60	-4,41	-2,62
Public debt		*24,06*	*24,29*	*24,82*	*24,82*	*22,76*	*20,14*	*17,72*	*14,79*	*12,16*	*9,85*	*8,78*
as % of GDP		67,10	71,70	73,00	74,70	70,40	59,60	56,20	45,40	41,80	32,80	28,30
	in billion EUR	**Q1 2017**	**Q1 2016**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**
Gross external debt		26,17	26,55	26,59	26,23	25,68	25,64	25,65	24,12	23,51	22,27	20,98
% of GDP		*73,7%*	*77,8%*	*77,9%*	*78,3%*	*77,1%*	*74,8%*	*80,9%*	*72,2%*	*79,0%*	*72,7%*	*62,3%*
Official foreign exchange reserves		9,73	9,50	10,20	10,38	9,91	11,19	10,91	12,06	10,00	10,60	8,16
% of GDP		*27,4%*	*27,8%*	*29,9%*	*31,0%*	*29,7%*	*32,7%*	*34,4%*	*36,1%*	*33,6%*	*34,6%*	*24,2%*
Net international investment position		-35,89	-	-35,53	-34,47	-32,74	-30,79	-	-	-	-	-
% of GDP		*-101,0*	-	*-104,2*	*-102,9*	*-98,3*	*-89,9*	-	-	-	-	-
Banking sector												
		2017	**2016**	**2016**	**2015**	**2014**	**2013**	**2012**				
	in billion EUR	**III**	**III**									
Total assets		25,88	24,76	26,25	25,06	24,54	24,83	25,32				
Total deposits		18,02	16,29	18,24	16,52	15,64	15,07	14,94				
Total loans		16,00	15,29	15,98	15,50	13,67	14,71	14,77				
Non-performing loans (gross) for total portfolio		2,76	3,31	2,80	3,49	3,48	3,45	3,22				
Pre-tax financial result		0,15	0,12	0,17	0,08	0,03	-0,02	0,10				
	annual growth rates (in %)											
Assets		5,4	3,4	6,4	2,7	4,3	-1,2	8,7				
Deposits		11,6	7,3	12,1	6,2	9,5	1,70	11,30				
Loans		5,6	1,2	4,7	-0,6	-2,5	-3,80	12,10				
	ratios (%)	**Q1 2017**	**Q1 2016**	**2016**	**2015**	**2014**	**2013**	**2012**				
NPLs ratio		*16,8*	20,9	17,0	21,6	21,5	21,4	18,6				

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Liquidity	36,3	34,2	36,9	34,3	35,6	38,5	34,5
Liquidity ratio	2,2	2,2	2,1	2,1	2,2	2,4	2,1
ROA	*2,3*	*1,9*	*0,7*	*0,3*	*0,1*	*-0,1*	*0,4*
ROE	*11,4*	*9,2*	*3,4*	*1,6*	*0,6*	*-0,4*	*2,1*

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