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Serbia **July 2018**	Radostina Stamenova, Lead Economic Analyst **stamenova@bcra-bg.com**
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SOVEREIGN RATING	Initial rating	Review	Review
Date of Rating Committee	31.07.2017	24.01.2018	17.07.2018
Date of rating publication	11.08.2017	26.01.2018	20.07.2018
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

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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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Overview:

Serbia is a candidate for European Union membership and could benefit from continued institutional improvements as part of the **EU accession process**. Official negotiations on Serbia's accession are opened in early 2014, and they are currently in process. After two more chapters were opened in December 2017, concerning corporate law (Chapter № 6) and international relations (Chapter № 30), in June 2018, the process is continued by opening the discussions on the Financial and budgetary provisions (Chapter № 33) and Fisheries (Chapter № 13). Thus, Serbia has so far opened 14 chapters in the pre-accession negotiations.

Dispute about **Serbia-Kosovo relations** has been reconfirmed as a major issue in the EU accession process of Serbia. Relations between Serbia and Kosovo have been tense since 2008, but in 2013 both countries agreed to participate in the EU-sponsored negotiations on normalizing relations, a condition for both countries to progress on their way towards membership in the bloc.

In line with the institutional and structural deficiencies the country faces, it comes the new phase of **Serbia-IMF collaboration**. On February 22, 2018, Serbia completed its participation in the three-year SBA with the IMF. The new PCI (policy coordination instrument) would not contain a financial component, however. The main idea of the agreement is for the IMF to provide counselling to the Serbian government in the following 30 months. Besides public finances, the PCI will also cover structural reforms in the country.

Following the **GDP growt**h of 1.9% in 2017, economic activity notably accelerates in the beginning of 2018. In the first quarter of 2018, GDP increases by 4.5% in real terms, driven by the domestic demand. Growth of employment and salaries, lower cost of financing, as well as favourable price trends, have all boosted spending, which results in 3.0% increase in household final consumption. Investments mark a strong rebound, as gross fixed capital formation increases by 14.9% in the first quarter, owing to further improvement of the business environment and implementation of infrastructure projects. Country's exports expand by 9.3%, while boosted by the higher domestic demand imports incur an acceleration to 12.5%. Thus, net exports generate negative impact on the GDP growth.

Services and industry retain the role of growth drivers, but construction sector has a growing contribution. The favourable trends in construction activity, observed in the second half of 2017, are well continued into early 2018, largely driven by the implementation of infrastructure projects. Thus, the construction sector growth significantly accelerates to 25.0% in the first quarter.

Serbia's largest **trade partners** are EU member states, which account for 66% of total exports and 62.4% of total imports in 2017. The progress in the approximation of the country to the European Union is accompanied by lowering of barriers to trade in goods. As a member of CEFTA, 17.5% of Serbian exports are absorbed by other CEFTA-member countries, whereas Bosnia and Herzegovina and Montenegro have largest contribution. Other countries with considerable presence in the international trade of Serbia are Russia and China.

In 2017, Serbia's **current account** deficit widens to EUR 2 090 mln (5.7% of GDP) from EUR 1 075 mln (3.1% of GDP) in the previous year. The deterioration is mostly attributable to the higher trade deficit and to a lesser extent the increased deficit of primary income account, while services and secondary income record surpluses. The current account deficit in the first quarter of 2018 stands at EUR 637 mln, being 8.3% lower compared to the same period of 2017.

FDI in the country are sufficient to fully cover the current account deficit, thus reducing the risks for the external sustainability. Net FDI inflows reach 6.6% of GDP in 2017, the highest level since 2011. Trends in the first quarter of 2018 show further improvement in the investment environment. Net FDI flows in the period January-March 2018 amount to EUR 595 mln, which is 6.5% increase compared to the same prior-year period. Favourable perception of foreign investors regarding long-term investment in Serbia is also confirmed by Serbia's advance in the World Bank's Doing Business Report.

Gross external debt records a downward trend mainly due to the decline in public indebtedness. At the end of March 2018, gross external debt stands at EUR 25 445 mln (63.3% of the projected GDP), decreasing by EUR 185 mln compared to the end of 2017. All indicators of external solvency improve as well.

At the end of March 2018, **NBS foreign exchange reserves** stand at EUR 10 636 mln. The level of reserves is sufficient for coverage of more than 5

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months of goods and services imports and ensures 243.6% coverage of short-term external debt, enough adequate to reduces the risk of inability to respond to unexpected events occurring on international markets.

Serbian **dinar** appreciation trends are still present in the first half of 2018, driven by strong exports, FDI inflows, and good fiscal performance. In June 2018, in comparison to the same month of 2017 foreign exchange rate records a nominal appreciation of 3.2% against the euro, reaching monthly average of 118.13 dinars per euro.

Inflation considerably decelerates in the first half of 2018. Consumer prices in June 2018 increase by 2.3% in relation to June 2017, while annual average inflation in the last 12 months decelerates to 1.7% compared to 3.4% in same prior year period. The slowdown is partly influenced by the higher base price of petroleum and food products which recorded one-off hikes in early 2017. In addition, the slowdown in inflation is also affected by the dinar appreciation. Inflationary pressure in medium-term may arise from the gradual increase in domestic demand but inflation is expected to remain well within the NBS target range in the absence of significant supply-side shocks.

Labour market indicates improved performance in line with real sector developments. The continued rise in employment is supported by concurrent increase in the activity rate. The unemployment rate (14.8% as of Q1 2018), however, remains at alarmingly high levels, much higher than in the representative EU-members, thus implying the presence of serious structural problems and obstacles standing before the economy.

GDP per capita in Serbia is much lower than the EU-average and also below the measure in neighbouring states like Romania and Bulgaria, which hold the last two 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. In nominal value the difference is even bigger - GDP per capita at current prices amounts to only 17.4% of the EU-average.

In 2017, both indicators of the **fiscal position** (primary and overall budget balance) record surpluses for the first time since 2005. Primary budget balance stands at EUR 1 430 mln (3.9 % of GDP), while overall budget balance records EUR 431 mln (1.2% of GDP) consolidated surplus. This result, much better than the initially planned deficit of 1.7% of GDP, is mostly due to better revenue collection. On the expenditure side, the most important contribution comes from lower interest expenditures, which is an indicator for the fiscal consolidation success.

Positive fiscal trends are well continued into early 2018. In the period January-April 2018, both primary and overall budget balance post surpluses. The 2018 Budget envisages a consolidated fiscal deficit in the amount of 0.7% of GDP.

Public debt is on a firm downward path. In 2017, total public debt of general government level decreases by 6.5% in nominal terms and by 10.5 p.p. as a share of GDP, reaching EUR 23 551 mln or 62.5% of GDP.

Since the majority of Serbian public debt is in dollars and euros, the appreciation of dinar compared to these currencies brought about an additional decrease of the share of public debt in GDP in 2017. However, the large amount of debt denominated in foreign currency carries risk due to possible unfavourable changes in the exchange rates. The interest rate risk is relatively low, given the small share of debt contracted at variable rates. Transferring from short-term financing resources to mid-term and long-term financing instruments, and the constant drop in borrowing costs, have influenced the reduction of refinancing risk.

At the end of April 2018, general government public debt stands at EUR 23 938 mln (59.5% of the projected GDP) The government is committed to keep public debt to GDP ratio firmly on a downward path, as the Fiscal Strategy for the period 2018 - 2018 envisages a fall in public debt to a level of 56.3% of GDP by 2020.

Yield on government securities continue to decline, backed by improved fundamentals and credibility of policies. The costs of government borrowing mark a falling trend since end-2012, triggered by the global developments in terms of policy relaxation. Further the drop is also backed by domestic factors - the successful application of fiscal consolidation measures, relatively stable exchange rate and low inflation.

The **key policy rate** has been continuously reduced in recent years, in line with the global financial environment of extremely low interest rates and narrowing spreads, accordingly. The central bank cut the key repo rate by 0.25 p.p. in September and October 2017 and then in March and April 2018, thus reaching 3.0%. The monetary

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policy easing in the context of low inflationary pressures will provide additional support to credit activity and economic growth.

Serbian **banking system** maintains high levels of liquidity (35.9% as of Q1 2018) and capital adequacy (22.7% as of Q1 2018) and the main bank aggregates (assets, deposits, and credits) remain nominally on the rise. Profitability also shows gradual improvement in recent years.

Although decreasing, the banking sector's **euroization** is still significant, which limits monetary policy effectiveness. The euro currency remains the preferred one holding over 60% in deposits and in credits of the households and non-financial corporations.

The quality of assets has been recognised as one of the main challenges that Serbian banking system faces as the **non-performing loans (NPL**) ratio varies around 1/5 of the gross loans' value during the 2012-2016 period. The dissatisfactory high portion of NPLs in credit portfolios triggered taking actions at national level to tackle the problem such as the implementation of a *NPL Resolution Strategy* (2015) and the respective action plans. The following positive results have become visible through the decreasing trend in the NPLs ratio since the beginning of 2016. As of Q1 2018, the ratio records its lowest after-crisis level of 9.2%. The *Decision on the Accounting Write-off of Bank Balance Sheet Assets* is last adopted in August 2017 by the National Bank of Serbia to encourage banks to continue resolving the NPLs in line with the Strategy.

Outlook:

The stable outlook of the Sovereign Rating of the Republic of Serbia reflects BCRA's opinion that the risks to country's development are balanced and currently do not affect the creditworthiness. The European Union accession process and the new arrangement with the IMF are expected to serve as an anchor for the fiscal stability and government's reform agenda.

BCRA would consider **upgrading** the Sovereign Rating and the Outlook for the Republic of Serbia if:

- The country marks an improvement in the institutional framework through faster progress on structural reforms directed towards the business environment;
- Public debt burden is further reduced;
- Increased resilience to external shocks is visible;

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

- Reversal in government's commitment for fiscal consolidation, resulting in a deterioration of the fiscal metrics;
- Delays of structural reforms, including restructuring the SOE sector;
- Intensification in external imbalances and capital outflow related to sudden shift in investors' sentiment;

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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 2018, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On July 17, 2018, 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**.

In the first quarter of 2018, Serbian economy reports strong growth supported by the increase in consumption and investment activity. The current account deficit of the balance of payments widens in 2017, but remains fully covered by the high FDI inflows in the country. The committee members discussed the sustainable improvement in the efficiency of public finance management. In 2017, general government budget reports a surplus for the first time since 2005. Due to fiscal consolidation measures, a significant reduction in government debt and interest costs has been achieved, which decreases the risk concerning debt repayments in short and medium term. The banking system preserves its growth potential and an improvement in asset quality is observed.

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

	2018 Q1	2017 Q1	2017	2016	2015	2014	2013
GDP, current prices (EUR millions)	8 850	7 964	36 795	34 617	33 491	33 319	34 263
Final consumption	8 312	7 574	32 311	30 592	30 444	31 104	31 885
Gross fixed capital formation	1 695	1 392	6 791	6 139	5 926	5 558	5 908
Inventories	-195	-202	935	466	388	271	140
Net exports	-961	-800	-3 242	-2 580	-3 266	-3 614	-3 669
Exports	4 838	4 357	19 299	17 316	15 632	14 452	14 116
Imports	5 798	5 157	22 541	19 896	18 898	18 066	17 786
GDP, real growth rate (%)	4.6	1.1	1.9	2.8	0.8	-1.8	2.6
Unemployment rate[1] (%)	14.8	14.6	13.5	15.3	17.7	19.2	22.1
Average net monthly wage (EUR)	415	367	395	374	368	380	388
CPI, annual average rate of change (%)	1.6	3.1	3.2	1.1	1.4	2.1	7.9
CPI, annual rate of change, end of period (%)	1.4	3.6	3.0	1.6	1.5	1.7	2.2
Average exchange rate RSD / EUR	118.43	123.88	121.34	123.12	120.73	117.31	113.14
Average exchange rate RSD / USD	96.33	116.19	107.50	111.29	108.85	88.54	85.17

EXTERNAL SECTOR

EUR million	2018 Q1	2017 Q1	2017	2016	2015	2014	2013
Current account, net	-637	-694	-2 090	-1 075	-1 234	-1 985	-2 098
Goods	-1 134	-927	-3 986	-3 119	-3 645	-4 111	-4 159
Services	226	220	951	907	729	465	313
Primary income	-529	-700	-2 570	-2 022	-1 658	-1 343	-1 419
Secondary income	800	713	3 516	3 159	3 340	3 003	3 166
Official foreign reserves	10 235	9 730	9 962	10 205	10 378	9 907	11 189
Gross external debt	25 445	26 113	25 630	26 494	26 234	25 679	25 644
International investment position	-36 159	-35 577	-35 723	-34 875	-34 113	-32 714	-30 827
% of GDP[2]							
Current account, net	-1.6	-1.9	-5.7	-3.1	-3.7	-6.0	-6.1
Goods	-2.8	-2.5	-10.8	-9.0	-10.9	-12.3	-12.1
Services	0.6	0.6	2.6	2.6	2.2	1.4	0.9
Primary income	-1.3	-1.9	-7.0	-5.8	-5.0	-4.0	-4.1
Secondary income	2.0	1.9	9.6	9.1	10.0	9.0	9.2
Official foreign reserves	25.5	26.4	27.1	29.5	31.0	29.7	32.7
Gross external debt	63.3	71.0	69.7	76.5	78.3	77.1	74.8
International investment position	-89.9	-96.7	-97.1	-100.7	-101.9	-98.2	-90.0

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PUBLIC FINANCE							
EUR million	2018 IV	2017 IV	2017	2016	2015	2014	2013
Consolidated public revenues	5 413	4 904	16 264	14 967	14 038	13 816	13 595
Consolidated public expenditures	5 355	4 732	15 833	15 405	15 273	16 017	15 469
Budget balance	58	172	431	-439	-1 235	-2 200	-1 875
Primary budget balance	515	641	1 430	630	-160	-1 219	-1 039
General government public debt	23 938	24 507	23 551	25 188	25 248	23 197	20 615
% of GDP[2]							
Consolidated public revenues	13.5	14.2	44.2	43.2	41.9	41.5	39.7
Consolidated public expenditures	13.3	13.7	43.0	44.5	45.6	48.1	45.1
Budget balance	0.1	0.5	1.2	-1.3	-3.7	-6.6	-5.5
Primary budget balance	1.3	1.9	3.9	1.8	-0.5	-3.7	-3.0
General government public debt	59.5	65.0	62.5	73.0	75.9	71.8	61.0

BANKING SYSTEM							
%	2018 Q1	2017 Q1	2017	2016	2015	2014	2013
Regulatory capital to risk weighted assets	22.7	22.3	22.6	21.8	20.9	20.0	20.9
Bank capital to assets	19.9	19.9	19.8	19.5	20.3	20.7	20.9
Liquid assets to total balance sheet assets	35.9	36.3	35.1	38.9	40.5	42.2	41.0
Loans to deposits ratio	94.5	92.9	93.2	92.0	99.0	102.7	113.8
Non-performing loans to total loans	9.2	16.8	9.8	17.0	21.6	21.5	21.4
Regulatory provisions to gross NPL	135.7	118.7	133.2	118.9	114.2	114.5	113.8
ROA	2.1	2.3	2.1	0.7	0.3	0.1	-0.1
ROE	10.5	11.4	10.6	3.4	1.6	0.6	-0.4

[1] Unemployment rate of population aged 15 years and over, Labour Force Survey.
[2]The GDP ratios for 2018 are calculated on the basis of GDP amounting to RSD 4 755 700 million (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*

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