12 May 2023 Sovereign and Public Sector

Republic of Serbia
Rating Report

STABLE OUTLOOK

BB+

Credit strengths

- Enhanced economic resilience, credible macroeconomic policy framework
- Solid medium-term growth prospects
- Moderate public debt, sound fiscal policy

Credit challenges

- Structural current account deficit, high net external debt
- High FX share of public and private debt
- Institutional weaknesses, slow progress on structural reform

Rating rationale:

Solid medium-term growth prospects: Serbia's economy has demonstrated improved resilience, bolstered by a credible macroeconomic policy framework. The near-term growth outlook for Serbia's small, open economy is hindered by factors such as high and prolonged inflation and tightening global and domestic financial conditions.

Moderate public debt and sound fiscal policies: Serbia's fiscal performance is supported by effective fiscal policies, complemented by continued reform efforts aimed at enhancing the fiscal policy framework.

Improved resilience to shocks: Despite a widening current account deficit, the National Bank of Serbia has rebuilt its gross international reserves since mid-2022, largely thanks to continued strong FDI inflows and recent external borrowing.

Rating challenges include: i) a structural current account deficit and substantial external debt; ii) a large share of government debt and private debt denominated in foreign currency; and iii) institutional weaknesses with a slow pace of structural reforms.

Serbia's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	bb+	RSD [+0]	0	BB+
Public Finance Risk		20%	aaa		0	
External Economic Risk		10%	cc		-1/3	
Financial Stability Risk		10%	aaa		-1/3	
ESG Risk	Environmental Factors	5%	aa-		-1/3	
	Social Factors	7.5%	bb-		0	
	Governance Factors	12.5%	cc		-1/3	
Indicative outcome		**bbb-**			**-1**	
Additional considerations					**0**	

Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced.

Positive rating-change drivers

- Debt/GDP ratio set on a firm downward trajectory over the medium run
- Substantive curtailment of external risks
- More durable resolution of institutional weaknesses and improvement in government capacity to reform

Negative rating-change drivers

- Steady increase in debt/GDP ratio in the medium run
- Increase in external vulnerabilities weighing on reserve adequacy
- External shock or sustained geopolitical risk undermining macro-financial stability

Ratings and Outlook

Foreign and local currency

Long-term issuer rating	BB+/Stable
Senior unsecured debt	BB+/Stable
Short-term issuer rating	S-3/Stable

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Bloomberg: RESP SCOP

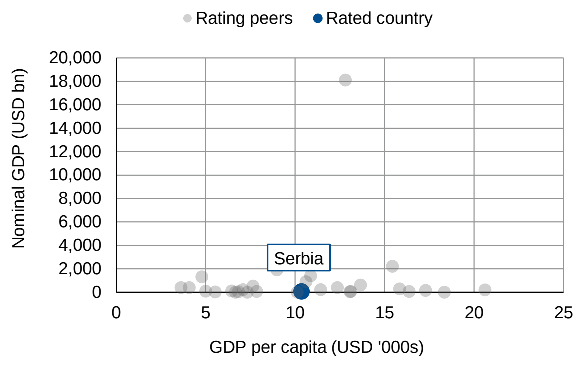
Domestic Economic Risks

- **Growth outlook:** In 2022, the Serbian economy has shown resilience despite various challenges and achieved a growth rate of 2.3%. Public investment is expected to remain high, and consumption is predicted to be the key driver of GDP growth in 2023. As a result of high commodity prices, lower real income growth, and weak demand from trading partners we forecast a real GDP growth of 2.0% in 2023. Energy security remains a significant concern, but the completion of an interconnector with Bulgaria in 2023 should help mitigate this risk. We forecast growth to pick up to 3% in 2024, and to reach its potential of about 4% over the medium term.
- **Inflation and monetary policy:** In February 2023, headline inflation peaked at 16.1% which was largely driven by a rise in food and energy prices. Core inflation also increased, reaching 11%. Despite inflation expectations being high, they have stabilized in recent months and are within the National Bank of Serbia's (NBS) inflation range. However, inflation is expected to decline gradually due to the hikes in gas and electricity prices agreed upon with the IMF. We project inflation to reach 9% YoY by the end of the year and inflation to fall within the NBS's target tolerance range by 2024. Following a 50 bp hike in December, the key policy rate was raised by 25 bp each in January and February, to 5.5%.
- **Labour market:** Despite the projected economic slowdown, we anticipate that the labour market will remain relatively stable. Labour market indicators have returned to pre-pandemic levels in the second half of 2021. However, shortages of skilled workers and high levels of youth unemployment are likely to pose longer-term challenges.

Overview of our qualitative assessments for Serbia's *Domestic Economic Risks*

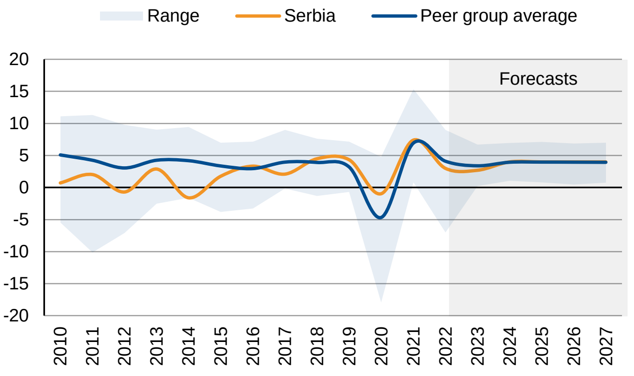
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Growth potential of the economy	Neutral	+1/3	Solid medium-run growth potential of 4%-4.5%, supported by steady net FDI inflows into the economy
	Monetary policy framework	Neutral	0	Pre-crisis track record of managed inflation, adequate monetary policy response to higher inflation
	Macro-economic stability and sustainability	Neutral	0	Improved macro-economic stability, but relatively low domestic savings

Nominal GDP and GDP per capita



Source: IMF WEO, Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

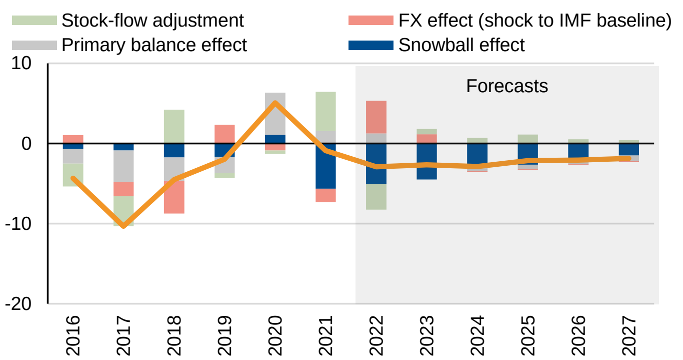
Public Finance Risks

- **Fiscal outlook:** We expect the Serbia to remain committed to fiscal discipline despite a challenging economic environment. The general government deficit was 3% of GDP in 2022, including fiscal support provided to the energy state-owned enterprises (SOEs) of about 2.5% of GDP. The government projects the deficit to narrow to 2% of GDP in 2023 and 1.5% of GDP in 2024, assuming a gradual phasing out of fiscal support measures from 2022. The credibility of the government's fiscal policy is supported by a good pre-crisis track record and an ongoing engagement with the IMF, which provides an anchor to the medium-term fiscal plan. However, the government's ongoing support for state-owned energy companies will continue to weigh on fiscal performance.
- **Debt trajectory:** Serbia's public debt is expected to decrease slightly, from 55.7% to 55.4% in 2023, and further decrease to 53.7% in 2024. The declining trajectory of Serbia's debt-to-GDP ratio is supported by the Serbia's stable fiscal position including strong revenue performance, coupled with efficient control over current spending. However, the budget has allowed for the possibility of issuing up to EUR 1bn in guarantees, which could result in future fiscal costs.
- **Market access:** Serbia has already secured a significant portion of the necessary funding for this year, with financing needs covered by supranational funding and a Eurobond issued in January. Serbia's return to the international capital markets in January with two substantially oversubscribed Eurobond issuances indicates a growing investor confidence. The planned funding requirements for 2023 total to EUR 5.5bn, which comprises of EUR 3.5bn in repayments and EUR 2bn in budget financing. This compares to fiscal reserves of around EUR 5bn by end-March. Moreover, EUR 0.6bn of Serbia's planned funding is set to be provided via the IMF's stand-by arrangement (SBA).

Overview of our qualitative assessments for Serbia's *Public Finance Risks*

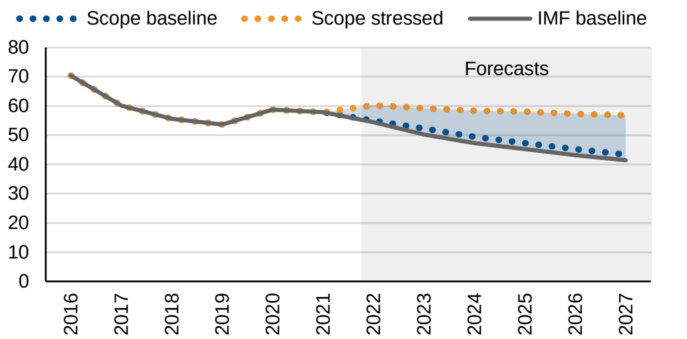
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Pre-crisis track record of fiscal prudence; development of new fiscal-rules framework and ongoing IMF policy support anchor fiscal discipline
	Debt sustainability	Neutral	0	Expected stabilisation and gradual decline in debt over medium run, but debt trajectory exposed to significant exchange-rate risk
	Debt profile and market access	Neutral	0	Improved market access; relatively long maturities and high share of multilateral, institutional debtholders but elevated share of FX debt

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

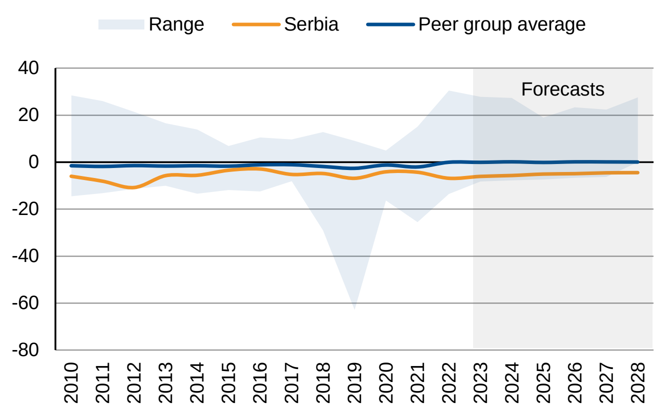
External Economic Risks

- **Current account:** The current account deficit rose to almost 7% of GDP in 2022, mainly due to a surge in energy imports. In 2023, the current account deficit as a share of GDP should decline slightly to 6.8% of GDP, requiring some external financing via Eurobond issuance. The current-account deficit should narrow to 5.6% of GDP in 2024, driven by lower energy imports and sustained export growth. Over the medium term, we project the current account deficit to decrease to around 5% of GDP.
- **External position:** The net external liability position of Serbia, which stems from ongoing current account deficits, continues to pose a credit weakness. As of Q2 2022, the net international investment position was equivalent to -83% of GDP, down from -90% of GDP in Q2 2020. However, around 60% of total external liabilities are in the form of inward FDI, which mitigates the risk of capital flight during periods of global financial turmoil.
- **Resilience to shocks:** Despite a widening current account deficit, the NBS has rebuilt its gross international reserves since mid-2022 to around EUR 21bn as of end-February, largely thanks to continued strong FDI inflows and recent external borrowing. The reserves are sufficient to cover five months' worth of imports of goods and services, as well as more than twice the amount of the country's short-term external debt. These levels exceed the adequacy thresholds set by the IMF, which recommend a reserve coverage of three months' worth of imports and 100% of short-term debt, thus providing a solid buffer in case FX interventions are required to safeguard the currency. Moreover, since last June, the dinar has mostly experienced appreciation pressure.

Overview of our qualitative assessments for Serbia's *External Economic Risks*

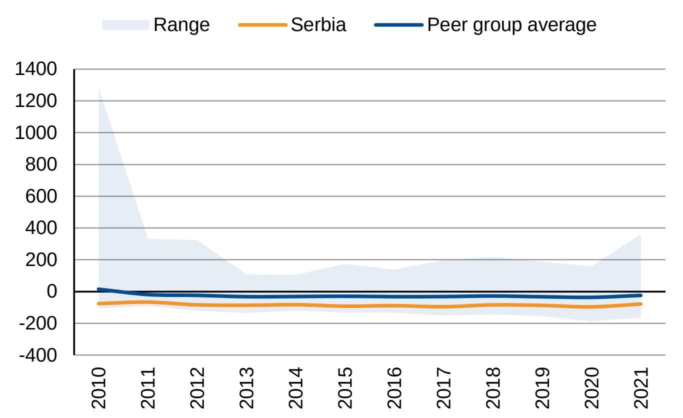
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
cc	Current account resilience	Weak	-1/3	Wide structural current account deficits due to high investment needs with relatively low domestic savings and narrow export base
	External debt structure	Neutral	0	Current account deficits are largely financed by FDI inflows; around 60% of total external liabilities relate to inward FDI decreasing risk of money flight during times of global market distress
	Resilience to short-term shocks	Neutral	0	Strong reserve coverage despite continued NBS interventions in the forex market to maintain the dinar's stability

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position, % of GDP



Source: IMF, Scope Ratings

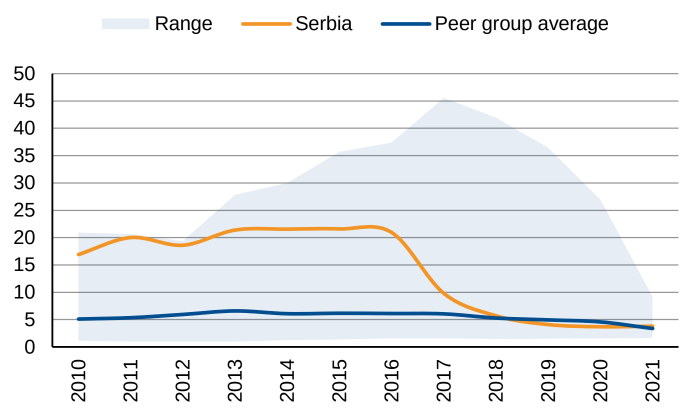
Financial Stability Risks

- **Banking sector:** Serbia's banking sector, which is mostly foreign-owned (accounting for over 80% of bank assets), poses a minimal risk to the sovereign balance sheet in terms of contingent liabilities. The banking sector has remained resilient and continues to be sufficiently capitalized and liquid. In December, the non-performing loan (NPL) ratio hit a new low of 3%, indicating that the quality of banks' assets has not been adversely affected by the increased costs of loan repayment due to higher interest rates.
- **Private debt:** Compared to other sovereigns with similar economic status, private sector involvement in Serbia's economy is relatively modest. This is partly because small and medium-sized enterprises, which are vital for the growth of the private sector, have limited access to financing. Despite this, the country's private external debt, which accounts for approximately 32% of GDP, has remained stable over the past few years, with over 90% of this debt being medium to long-term.
- **Financial imbalances:** Around 65% of deposits and loans in the banking sector are foreign currency denominated, exposing the balance sheets of banks and private sector to FX risk. Throughout Q4, the National Bank of Serbia (NBS) maintained its policy of tightening monetary conditions, resulting in an increase in interest rates in the interbank money market. This, in turn, led to an increase in interest rates for dinar loans and savings. Additionally, the European Central Bank (ECB) also pursued a policy of tightening monetary conditions, which resulted in higher interest rates for both euro loans and deposits.

Overview of our qualitative assessments for Serbia's *Financial Stability Risks*

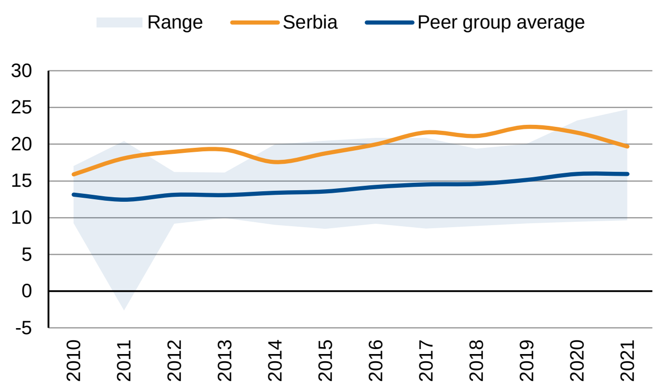
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Mostly foreign-owned, well-capitalised and liquid banking sector; low contingent liability risk to the sovereign balance sheet
	Banking sector oversight	Neutral	0	Conservative banking framework supports overall stability in the system, macroprudential tools framework regarded as 'equivalent' to the EU one
	Financial imbalances	Weak	-1/3	High euroization of deposits and loans (at around 65% of the total) represents a financial stability concern

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

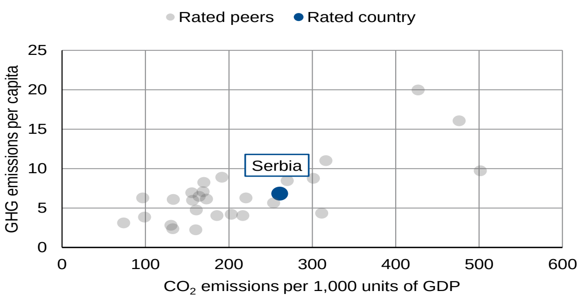
ESG Risks

- **Environment:** Serbia faces a significant challenge in reducing emissions as its economy has a high energy intensity, nearly four times that of the EU. Coal remains a primary source of electricity production, with lignite coal accounting for about two-thirds of electricity generated in 2021. Although wind power has experienced significant growth in recent years, it still only generated 2.4% of electricity in 2021. The planned completion of a gas pipeline between Serbia and Bulgaria by the end of 2023, funded by a EUR 49.6m EU grant and a EUR 25m EIB loan, is expected to transfer 1.8 bcm of natural gas annually, equivalent to 60% of Serbia's annual consumption. This pipeline will enhance the diversification of energy sources in Serbia and improve the stability and security of its gas supply.
- **Social:** Serbia's labour market faces challenges in the longer term due to demographic trends, including an ageing population and emigration, which limit labour supply. According to the UN, the old-age dependency ratio (the ratio of those aged 65 years or over to those aged 15-64) is expected to rise to over 35% by 2030, up from 31.6% in 2022. However, there have been some positive developments in migration flows, with an influx of skilled workers and foreign students in recent years.
- **Governance:** We expect economic and foreign policy continuity following the victory of President Vucic and his SNS party in presidential and parliamentary elections last year. Serbia's proposed new fiscal rules and IMF policy coordination demonstrate a commitment to balancing fiscal discipline and growth. However, we expect only gradual progress on other major structural reforms to reduce long-standing public sector inefficiencies, including of public administration and state-owned enterprises. In addition, a broader normalisation of relations between Serbia and Kosovo and substantial reform around the rule of law, the most crucial preconditions for Serbia's EU accession, are likely to remain a longer-term challenge.

Overview of our qualitative assessments for Serbia's *ESG Risks*

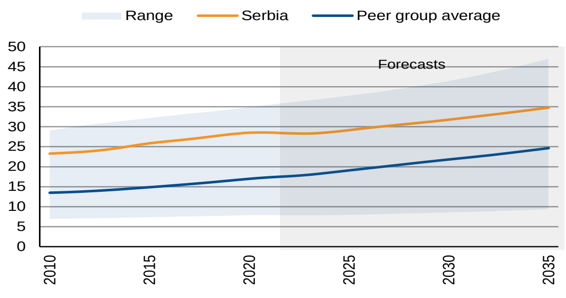
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Environmental risks	Weak	-1/3	Diversification of energy sources via EU funding and green issuances, but elevated energy reliance on coal
	Social risks	Neutral	0	An ageing population and emigration constrain labour supply; elevated youth unemployment rate
	Institutional and political risks	Weak	-1/3	Institutional weaknesses; lack of tangible progress towards a sustainable settlement with Kosovo

CO_2 emissions per GDP, $mtCO_2e$



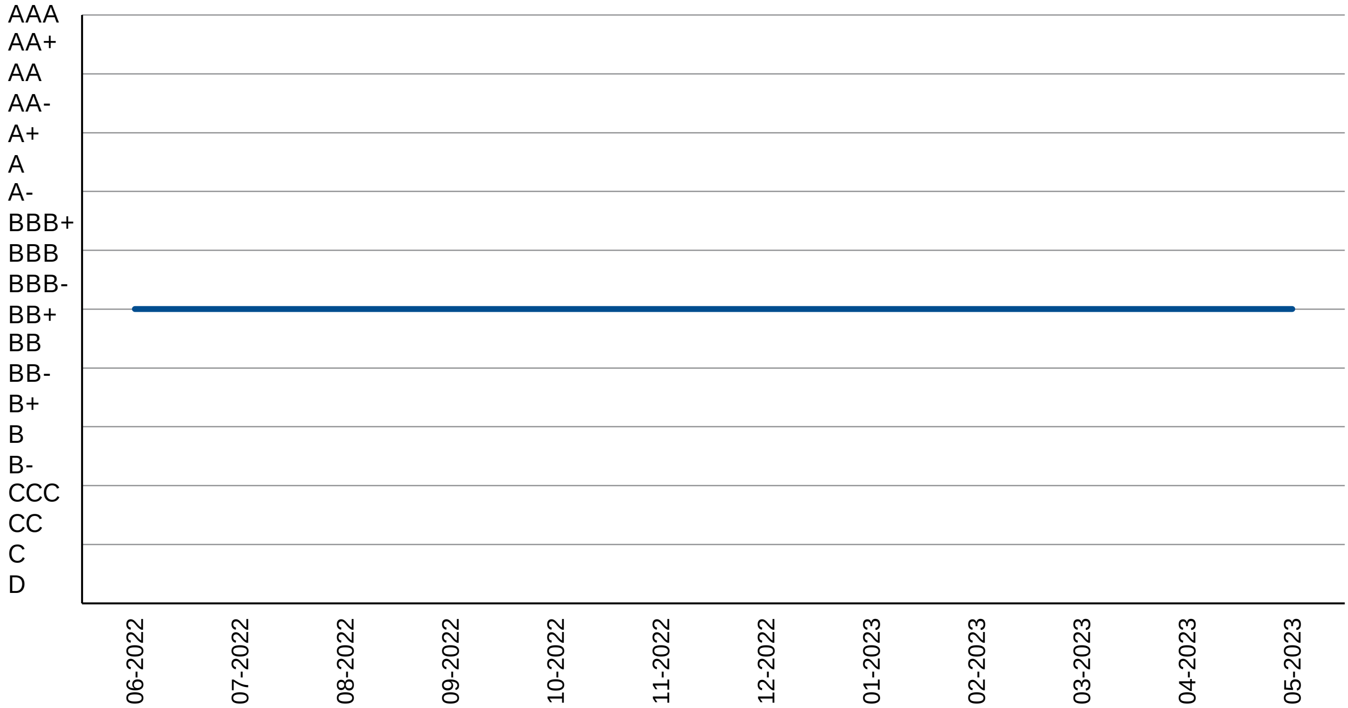
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard.

Peer group*
Bulgaria
China
Georgia
Greece
Hungary
Romania
Turkey

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2018	2019	2020	2021	2022	2023
Domestic Economic	**GDP per capita, USD '000s**	IMF	7.3	7.4	7.7	9.2	10.4	10.8
	Nominal GDP, USD bn	IMF	50.6	51.5	53.4	63.1	70.9	74.0
	Real growth, %	IMF	4.5	4.3	-0.9	7.6	2.3	2.0
	CPI inflation, %	IMF	2.0	1.9	1.6	4.1	12.0	12.2
	Unemployment rate, %	WB	12.7	10.4	9.0	10.1	-	-
Public Finance	**Public debt, % of GDP**	IMF	53.3	51.7	56.9	56.3	53.5	50.2
	Interest payment, % of revenue	IMF	5.2	4.8	4.9	4.0	3.5	4.0
	Primary balance, % of GDP	IMF	3.0	2.0	-5.2	-1.6	1.4	0.7
External Economic	**Current account balance, % of GDP**	IMF	-4.8	-6.9	-4.1	-4.3	-6.9	-6.1
	Total reserves, months of imports	IMF	4.7	5.2	6.1	5.3	-	-
	NIIP, % of GDP	IMF	-84.9	-88.3	-97.2	-79.5	-	-
Financial Stability	**NPL ratio, % of total loans**	IMF	5.7	4.1	3.7	3.8	-	-
	Tier 1 ratio, % of risk-weighted assets	IMF	21.8	21.1	21.9	21.4	18.9	-
	Credit to private sector, % of GDP	WB	41.4	42.0	45.5	-	-	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	365.1	355.4	346.2	261.0	-	-
	Income share of bottom 50%, %	WID	17.8	17.8	17.8	17.8	-	-
	Labour-force participation rate, %	WB	67.4	67.6	-	-	-	-
	Old-age dependency ratio, %	UN	27.5	28.1	28.5	28.5	28.4	28.3
	Composite governance indicators*	WB	-0.1	-0.1	-0.1	-0.1	-	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging market
5y USD CDS spread (bps) as of 12 May 2023	257

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