3 June 2022

Sovereign and Public Sector

Republic of Serbia
Rating Report

BB+ STABLE OUTLOOK

Credit strengths

- Enhanced economic resilience
- Solid medium-term growth prospects
- Moderate public debt, prudent fiscal policy

Credit challenges

- Structural current account deficit
- High foreign-currency share of public and private debt
- Institutional weaknesses

Rating rationale:

Serbia's BB+ rating is supported by its economic resilience and solid medium-term growth prospects, underpinned by its credible macroeconomic policy framework and a steady inflow of net foreign direct investment (FDI). In addition, Serbia's rating benefits from its moderate public debt, supported by prudent fiscal policy and the continuation of reforms to enhance the fiscal framework.

However, the Russia-Ukraine war is exerting downward pressure on Serbia's small, open economy via higher inflationary pressures, lower business and consumer confidence, and foreign trade and supply chain disruptions – all of which pose downside risks to the near-term growth.

In addition, the BB+ rating is constrained by persistent wide current account deficits, a high degree of banking sector euroization, a large share of public debt denominated in foreign currency (euros and dollars) and institutional weaknesses.

Serbia's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	bbb-		0	BB+
Public Finance Risk		25%	aa		0	
External Economic Risk		10%	ccc		-1/3	
Financial Stability Risk		10%	a-		-1/3	
ESG Risk	Environmental Risk	5%	a-		-1/3	
	Social Risk	5%	bb		0	
	Governance Risk	10%	cc		-1/3	
Overall outcome		**bbb-**		**0**	**-1**	

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 the Serbian economy will be able to weather the near-term economic fallout from the Russia-Ukraine war without any substantial deterioration in credit fundamentals.

Positive rating-change drivers

- Debt/GDP ratio set on a firm downward trajectory over the medium run
- Raising of medium-run growth prospects through structural reform
- Substantive curtailment of external vulnerabilities
- 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 due to looser fiscal policies, weaker growth and/or forex depreciation
- Increase in external vulnerabilities, due to worsening market conditions or widening of imbalances
- External shock or heightened and 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

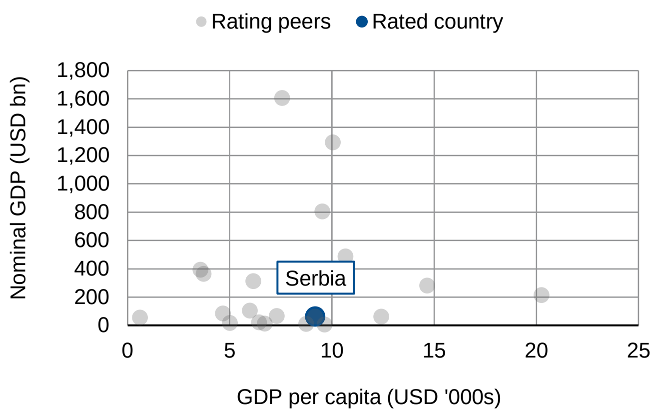
Domestic Economic Risks

- **Growth outlook:** Serbia achieved a pre-pandemic level of output much faster than most of its sovereign peers. The economy recovered strongly from the pandemic recession, growing 7.4% in 2021 – driven by a recovery in industrial production, construction and the services sector – which followed a mild contraction of 0.9% in 2020. Despite heightened near-term macroeconomic risks, Scope expects the Serbian economy to weather the economic fall-out from the Russia-Ukraine war. Real GDP growth in Q1 2022, estimated at 4.2% YoY, was only slightly below pre-war expectations. Scope forecasts that Serbia will grow by 3% in 2022 before stabilising at 4% in 2023, broadly in line with the country's growth potential of 4%-4.5% over the medium term, underpinned by planned infrastructure investment projects and steady FDI inflows.
- **Inflation and monetary policy:** Headline inflation surged to 9.6% YoY in April 2022, the fastest rise in almost nine years and well above the National Bank of Serbia (NBS) target of 3% (±1.5%). At the same time, core inflation (excluding prices for food, energy, alcohol and cigarettes) remained markedly below headline inflation, at 5.5% YoY in April. We forecast average yearly headline inflation close to the double-digit mark in 2022, at 9%. The Russia-Ukraine conflict will add to strong inflationary pressures in the short term due to higher prices for energy, commodities and food. To curb inflation and anchor medium-run inflation expectations, NBS has started tightening its policy – hiking up the key rate twice by 50bps, to 1.5% in April and to 2% in May. Inflation levels are projected to normalize towards the NBS' tolerance band of 4.5% in 2023, without negative repercussions for the country's credit fundamentals.
- **Labour market:** We see no major risks to the labour market from the Russia-Ukraine conflict, with labour market indicators having recovered to pre-pandemic levels at end-2021. At the same time, skilled labour shortages and elevated youth unemployment (28.7% in Q4 2021) remain longer-term challenges. We note positively the authorities' economic migration strategy, assisting the return of skilled workers, as well as the extension of existing policies aimed at supporting youth employment.

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

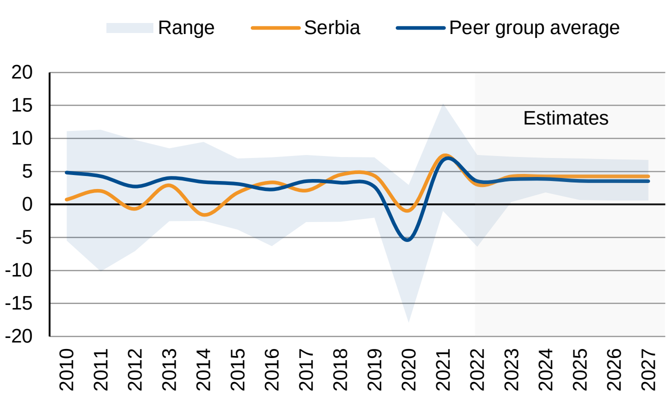
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Growth potential of the economy	Neutral	0	Solid medium-run growth potential of 4%-4.5%, supported by steady net FDI inflows; demographics are a constraint
	Monetary policy framework	Neutral	0	Pre-crisis track record 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, small open economy and elevated youth unemployment rate

Nominal GDP and GDP per capita



Source: IMF WEO, Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

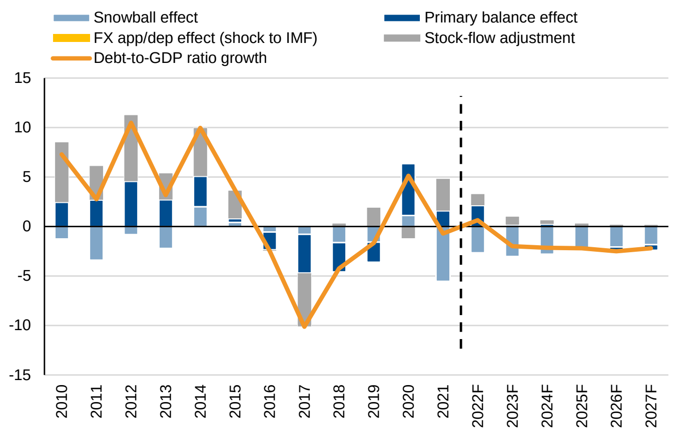
Public Finance Risks

- **Fiscal outlook:** We expect the government to remain committed to fiscal discipline despite increasing budgetary pressures. The general government deficit is forecast to reach 3.5% of GDP this year, largely unchanged compared to 2021. The deficit is projected to narrow to 2% of GDP in 2023 and 1.5% of GDP in 2024, assuming a phasing out of support measures from 2022. The credibility of the government's fiscal plans is supported by a good pre-crisis track record of fiscal prudence and an ongoing engagement with the IMF, which provides an anchor to the medium-term fiscal framework. Serbia is developing a new fiscal rules framework in consultation with the IMF, planned to become effective with the 2023 budget. The new system will stipulate a lower ceiling for the budget deficit and define key elements such as debt thresholds, escape clauses and correction mechanisms.
- **Debt trajectory:** As a result of the expected gradual reduction in the medium-run budget deficit, we project that general government debt will stabilise at 57% of GDP in 2022 and decline to 55% of GDP by 2023. Still, around 74% of debt was in foreign currency in March, of which 58% was in euros and 11% in dollars, making the debt trajectory vulnerable to forex volatility. This risk is mitigated by a stable exchange rate. In addition, the large share of fixed-rate debt (84%), relatively long maturities (around 80% of RSD government securities have a maturity of five years and over), and a high share of multilateral and institutional debt holders (around 45% of government external debt) represent important mitigating factors.
- **Market access:** Serbia's fiscal outlook benefits from its enhanced debt management as well as improved access to foreign investors. The inclusion of three dinar-denominated benchmark sovereign bonds in the JP Morgan Emerging Market Index since June 2021 supports the demand for Serbian debt. Furthermore, we expect a Euroclearable market link to become operational in 2022. This will enable foreign investors to access Serbia's domestic capital markets in a more secure and standardised way, moderately supporting market liquidity.

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

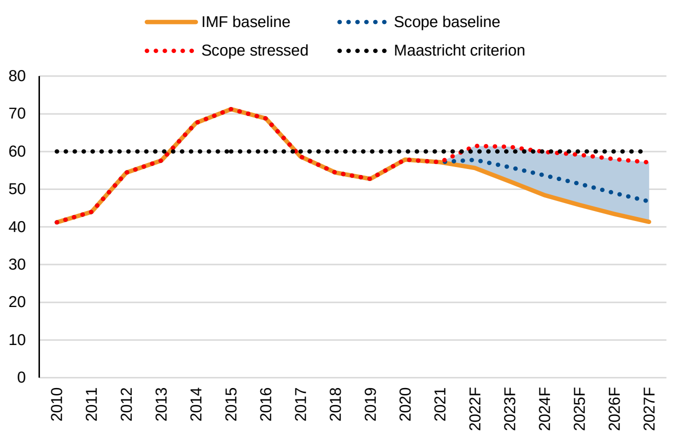
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Fiscal policy framework	Neutral	0	Pre-crisis track record of fiscal prudence; development of new fiscal-rules framework and ongoing IMF policy support anchor medium-run fiscal discipline
	Debt sustainability	Neutral	0	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 due to inclusion in GBI-EM indexes and upcoming Euroclear link; relatively long maturities and high share of multilateral, institutional debtholders, but three-quarters of debt is in forex

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

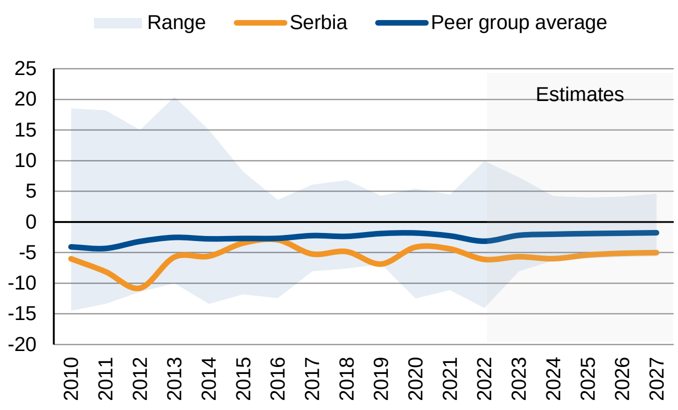
External Economic Risks

- **Current account:** We expect Serbia's current account deficit to widen to 6% of GDP this year, from 4.4% of GDP in 2021, mainly due to the impact of increasing commodity prices. Our projection of a medium-run current account deficit at around 5% of GDP reflects the high investment needs of a developing economy with relatively low domestic savings and a narrow export base. At the same time, we do not expect major risks on the financing side, as net inflows of FDI are projected to finance current account deficits in the next few years. Since 2015, net FDI inflows have exceeded the current account deficit, reaching EUR 3.6bn (6.8% of GDP) in 2021. Over 2019-2021, most FDI inflows came from EU countries (57%), while China increased its share to 15%.
- **External position:** Serbia's significant net external liability position remains a credit weakness. The net international investment position equalled -83.9% of GDP at end-2021, significantly below the average for sovereign peers. Around 60% of total liabilities relate to inward FDI, which decreases the risk of money flight during times of global market distress.
- **Resilience to shocks:** The NBS forex reserve position remains comfortable, despite continued interventions in the forex market since the outbreak of Covid-19 and the war in Ukraine to maintain the dinar's stability. Gross NBS forex reserves stand at EUR 14.1bn at end-April, down from EUR 16.5bn at end-2021, mainly reflecting forex sales, which totalled EUR 155m in April and EUR 2.27bn net in the four months of 2022. The level of NBS forex reserves nonetheless covers five months' worth of Serbia's import of goods and services and around two times its short-term external debt, which are well above IMF adequacy thresholds of 100% of short-term debt or the equivalent of three months' worth of imports.

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

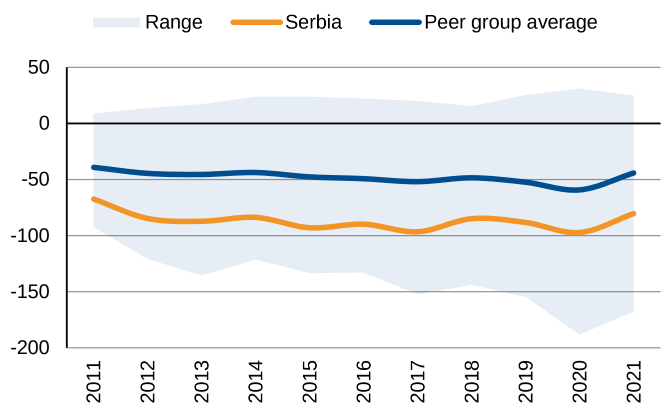
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Weak	-1/3	Wide structural current account deficits due to high investment needs with relatively low domestic savings and narrow export base
	External debt structure	Neutral	0	Current account deficits are 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 since the outbreak of Covid-19 and the war in Ukraine 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

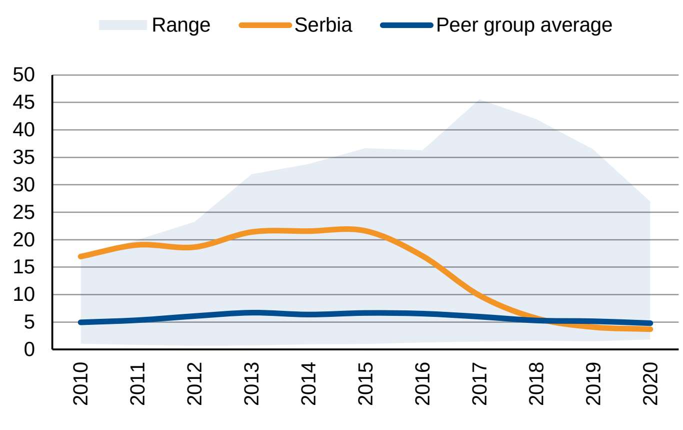
Financial Stability Risks

- **Banking sector:** Serbia's mostly foreign-owned banking sector presents low contingent liability risk to the sovereign balance sheet, also considering the recent acquisition of the largest state-owned bank Komercijalna Banka by Slovenia's NLB Group. The banking sector remains well capitalised and liquid with a system-wide Tier 1 capital of 19.7% of risk-weighted assets and a loan-to-deposit ratio of 85% at end-2021. The NBS' conservative banking framework supports overall stability in the system, while its macroprudential tools framework is regarded as 'equivalent' to the EU one.
- **Private debt:** In general, the degree of private sector engagement in the Serbian economy is moderate compared to sovereign peers. This, in part, is due to limited access to finance for small and medium sized enterprises, which are key for the Serbian private sector. Private external debt amounts to around 30% of GDP, largely unchanged over the past years.
- **Financial imbalances:** The euroisation of deposits and loans remains high at almost 60% of the total stock, representing a financial stability concern. At the same time, the non-performing loan ratio fell to 3.5% at end-February, from 3.7% at end-2020 (and from a peak of 21.6% at end-2015), driven by a successful implementation of non-performing loan resolution activities, including repayments, write-offs and sales.

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

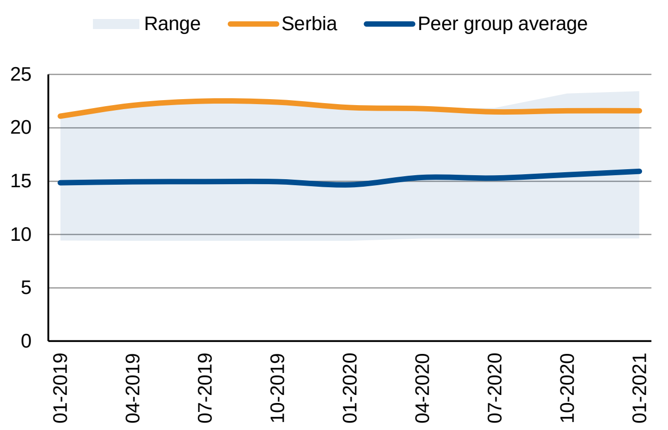
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Banking sector performance	Neutral	0	Mostly foreign-owned, well-capitalised and liquid banking sector; low contingent liability risk to the sovereign balance sheet
	Banking sector oversight	Neutral	0	Conservative banking framework supports overall stability in the system, macroprudential tools framework regarded as 'equivalent' to the EU one
	Financial imbalances	Weak	-1/3	High euroisation of deposits and loans (at almost 60% 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

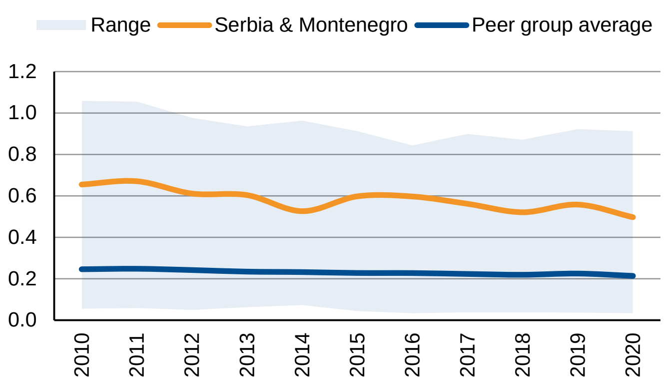
ESG Risks

- **Environment:** Serbia opened the 'Green Agenda and Sustainable Connectivity' cluster in accession talks with the EU in December 2021, which is related to transport, energy, trans-European networks, environmental protection and climate change. Serbia will use the receipts from the EUR 1bn green Eurobond to finance projects from its environmental and climate agenda, including the construction of water plants, flood protection, waste management, recycling infrastructure, subways and energy efficiency. At the same time, Serbia has a high energy intensity, nearly four times the EU average. Electricity production in Serbia relies heavily on coal (around two-thirds of electricity generated in 2021 came from lignite coal), which is a challenge given the priority of significantly reducing emissions. Despite strong growth in wind power in recent years, it generated only 2.6% of electricity in 2021.
- **Social:** Serbia's labour market growth in the longer term is hindered by demographic trends, reflecting an ageing population and emigration, which constrain the labour supply. The old-age dependency ratio (those aged 65 years or over as a percentage of those aged 15-64) increased to 33% in 2020, from 29% in 2016. At the same time, there has been some improvement in migration flows, which is attributable to the immigration of highly skilled workers and foreign students more recently.
- **Governance:** We expect economic and foreign policy continuity following the victory of President Vucic and his SNS party in April's presidential and parliamentary elections. Serbia's proposed new fiscal rules and IMF policy support demonstrate a commitment to balancing fiscal discipline and growth while anchoring medium-term fiscal expectations. However, we expect only gradual progress on other major structural reforms, including of public administration, state-owned enterprises and the reduction of long-standing public sector inefficiencies. In addition, we believe that the ongoing centralisation of political power could undermine long-term policy predictability, with negative implications for investor confidence. In our view, 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. We therefore expect the accession target date of 2025 to be delayed considerably.

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

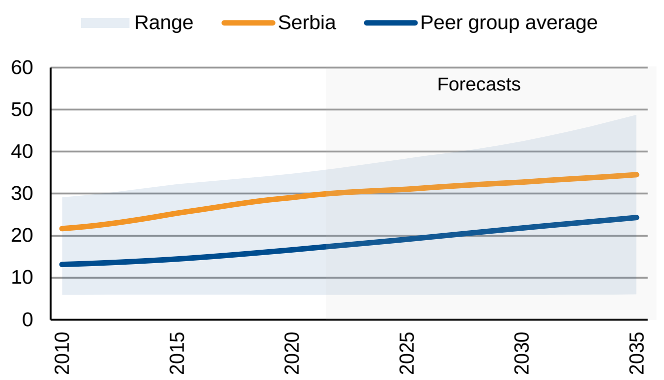
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Environmental risks	Weak	-1/3	Enhanced legislative framework, opening of 'Green Agenda and Sustainable Connectivity' cluster in EU accession talks, but elevated energy reliance on coal
	Social risks	Neutral	0	An ageing population and emigration constrain labour supply, but improvements in immigration flows in recent years
	Institutional and political risks	Weak	-1/3	Comparatively weak institutional settings; ongoing centralisation of decision-making; absence 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. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29 – with the governance indicator reflecting a composite of six indicators) used in our quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	5.8	6.3	7.3	7.4	7.7	9.2	9.5	10.6
Nominal GDP, USD bn	40.7	44.2	50.6	51.5	53.3	63.1	65.0	72.6
Real growth, %[1]	3.3	2.1	4.5	4.3	-0.9	7.4	3.0	4.0
CPI inflation (AVG), %	1.1	3.1	2.0	1.9	1.6	4.1	9.0	4.5
Unemployment rate, %[1]	16.9	14.9	14.1	11.6	10.1	11.4	11.0	10.0
Public Finance Risk								
Public debt, % of GDP[1]	68.8	58.6	54.4	52.8	57.9	57.2	57.0	55.0
Net interest payment, % of government revenue	7.1	6.1	5.2	4.8	4.9	4.0	4.5	4.3
Primary balance, % of GDP[1]	1.8	3.9	3.0	2.0	-5.2	-1.6	-1.6	0.2
External Economic Risk								
Current account balance, % of GDP	-2.9	-5.2	-4.8	-6.9	-4.1	-4.4	-6.0	-5.5
FX reserves, in months of imports of goods and services	6.2	5.4	5.4	5.7	6.1	6.0	-	-
NIIP, % of GDP	-94.3	-90.6	-87.5	-88.0	-90.3	-83.9	-	-
Financial Stability Risk								
NPL ratio, % of total loans	17.0	9.9	5.7	4.1	3.7	3.6	-	-
Tier 1 ratio, % of risk-weighted assets	20.0	21.6	21.1	22.4	21.6	19.7	-	-
Credit to private sector, % of GDP	32.1	33.5	36.1	37.9	42.3	41.4	-	-
ESG Risk								
CO2 per USD 1,000 of GDP	596.6	561.0	520.1	557.3	496.0	-	-	-
Income quintile share ratio (S80/S20)	9.7	8.0	6.9	6.4	-	-	-	-
Labour-force participation rate, %	65.1	66.2	67.4	67.6	-	-	-	-
Old-age dependency ratio, %	29.2	30.3	31.3	32.4	33.0	-	-	-
Composite governance indicator[2]	0.0	0.0	0.0	-0.1	-0.1	-	-	-

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Worldwide Governance Indicators
Source: National statistical office and central bank, European Commission, IMF, World Bank, Scope Ratings

Appendix II. Economic development and default indicators

IMF Development Classification	Emerging market/Developing economy
5y USD CDS spread (bps) as of 03 June 2022	299

Appendix III. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per our Core Variable Scorecard embedding a methodological reserve-currency adjustment.

Peer group*
Georgia
Greece
Romania
Turkey

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

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