Republic of Serbia
Rating Report

SCOPE BB+ STABLE OUTLOOK

Credit strengths

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

Serbia's BB+ rating is supported by improved economic resilience and solid medium-term growth prospects, underpinned by a credible macroeconomic policy framework and a steady inflow of FDI.

Serbia's rating benefits from moderate public debt and a prudent fiscal policy. The IMF and Serbia reached a staff-level agreement on a 24-month EUR 2.4bn (4% of 2022 GDP) arrangement in November. The IMF funding will help address Serbia's external and fiscal financing needs. The upcoming adoption of a new fiscal rule will help anchor fiscal consolidation and rebuild fiscal buffers.

However, Russia's war in Ukraine is exerting downward pressure on Serbia's small, open economy. High and prolonged inflation, tighter global and domestic financial conditions, a projected slowdown in European economies and supply-chain disruptions pose downside risks to near-term growth.

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

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. Scope expects the accession target date of 2025 to be delayed considerably.

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%	bb+		0	BB+
Public Finance Risk		25%	aaa		0	
External Economic Risk		10%	cc		-1/3	
Financial Stability Risk		10%	aaa		-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 Serbia will be able to weather the near-term economic fallout from the Russia-Ukraine war without 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 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 due to looser fiscal policies, weaker growth and/or forex depreciation
- Increase in external vulnerabilities, due to worsening market conditions or wider 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

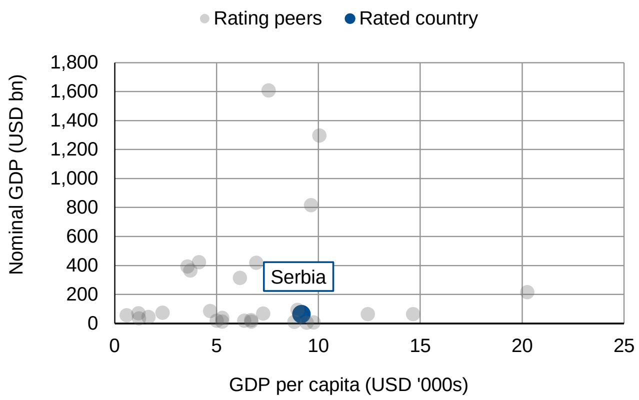
Domestic Economic Risks

- **Growth outlook:** Serbia achieved a pre-pandemic level of output much faster than most of its sovereign peers. The economy recovered strongly 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, we expect the Serbian economy to weather the economic fall-out from the Russia-Ukraine war due to its improved resilience. We forecast a real GDP growth of 3% in 2022 – unchanged from our last review in June – and down to 2.7% in 2023 (1.3pps downward revision from our June forecast) driven by a projected slowdown in European economies, tightening global and domestic financial conditions and the negative impact of high and prolonged inflation on household purchasing power. We estimate Serbia's growth potential at 4%-4.5% in the medium term, underpinned by implementation of infrastructure investment projects and steady FDI inflows.
- **Inflation and monetary policy:** Headline inflation surged to 14% YoY in September 2022, the fastest rise in over a decade 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 8.6% YoY in September. We forecast average yearly headline inflation above the double-digit mark in 2022, at 12%. 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 seven consecutive times from 1% in April to 4% currently. More hikes for the remainder of the year and at the beginning of next year are possible. Inflation is projected to normalize towards the NBS' tolerance band of 4.5% by the first half of 2024, without significant negative repercussions for the country's credit fundamentals.
- **Labour market:** We do not expect substantial deterioration in the labour market from the projected economic slowdown, with labour market indicators having recovered to pre-pandemic levels already in the second half of 2021. However, skilled labour shortages and elevated youth unemployment at 18.7% in Q2 2022 remain longer-term challenges. We note positively the authorities' economic migration strategy, assisting the return of skilled workers from abroad, as well as the extension of existing policies aimed at supporting youth employment.

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

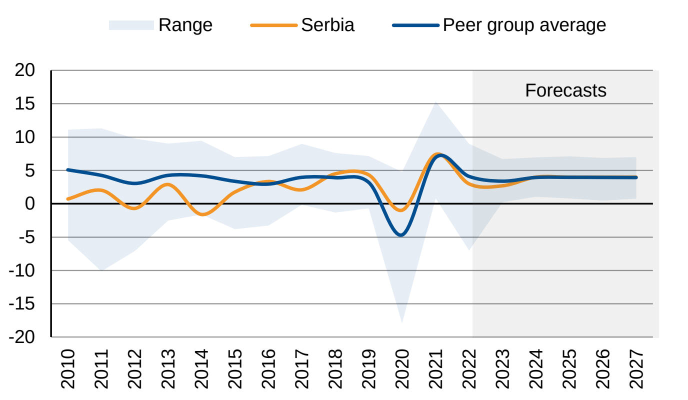
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Growth potential of the economy	Neutral	0	Solid medium-run growth potential of 4%-4.5%, supported by steady net FDI inflows into the economy
	Monetary policy framework	Neutral	0	Pre-crisis track record of managed inflation,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

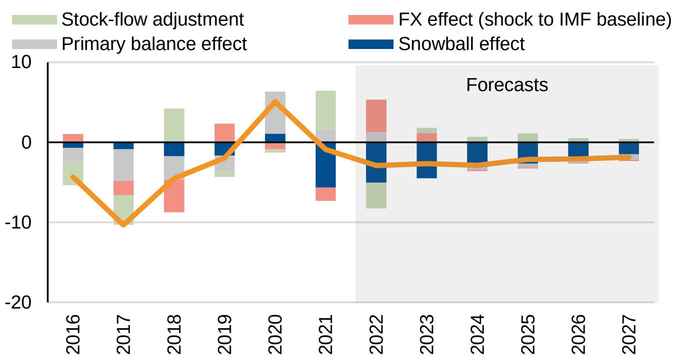
Public Finance Risks

- **Fiscal outlook:** We expect the Serbian authorities to remain committed to fiscal discipline despite a challenging economic environment. The general government deficit is forecast to reach 3% of GDP this year, largely unchanged over 2021. The deficit is projected 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. The IMF and Serbia reached a staff-level agreement on a 24-month EUR 2.4bn (4% of 2022 GDP) arrangement in November – subject to approval by the IMF Executive Board in December. The IMF financing will help support Serbia's budget and spending programs. The upcoming adoption of a new fiscal rule in 2023, developed in consultation with the IMF, will help anchor fiscal consolidation and rebuild fiscal buffers. The new rule will stipulate a lower ceiling for the budget deficit and introduce key elements such as debt thresholds, escape clauses and correction mechanisms.
- **Debt trajectory:** As a result of a projected gradual reduction in medium-run budget deficit and high and prolonged inflation, we expect the general government debt-to-GDP ratio to return to a downward trajectory in the coming years. We project debt-to-GDP at 55% in 2022 and down to 52% in 2023. Around 75% of debt was in foreign currency as of September, of which 57% was in euros and 12% in dollars, making the debt trajectory vulnerable to FX volatility. The FX risk is mitigated by a stable exchange rate. In addition, the large share of fixed-rate debt (83%), a high share of multilateral and institutional creditors in external debt and relatively long maturities in domestic debt (over 80% of RSD government securities have a maturity of five years and over), represent important mitigating factors.
- **Market access:** Serbia's fiscal outlook and the cost of borrowing benefit from an enhanced debt management and an improved access to investors. The inclusion of three dinar-denominated benchmark sovereign bonds in the JP Morgan Emerging Market Index since June 2021 supports demand for Serbian local-currency debt. The Serbian government supports dinarisation of debt through tax policy, promoting the development of the dinar securities market. The upcoming access to Euroclear settlement (by early 2023) will support the market conditions for Serbia's debt.

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

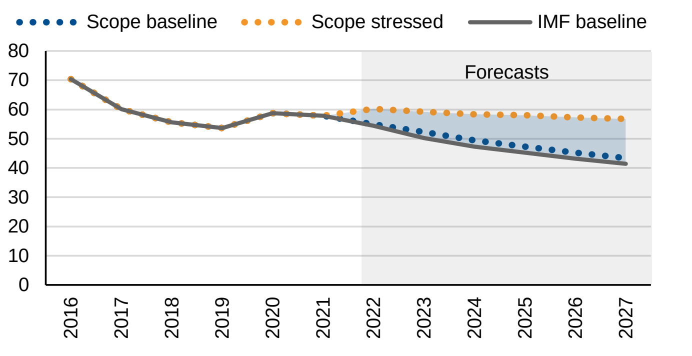
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Fiscal policy framework	Neutral	0	Pre-crisis track record of fiscal prudence; development of new fiscal-rules framework and ongoing IMF policy support anchor fiscal discipline
	Debt sustainability	Neutral	0	Expected 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 due to inclusion in GBI-EM indexes and upcoming Euroclear link; 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

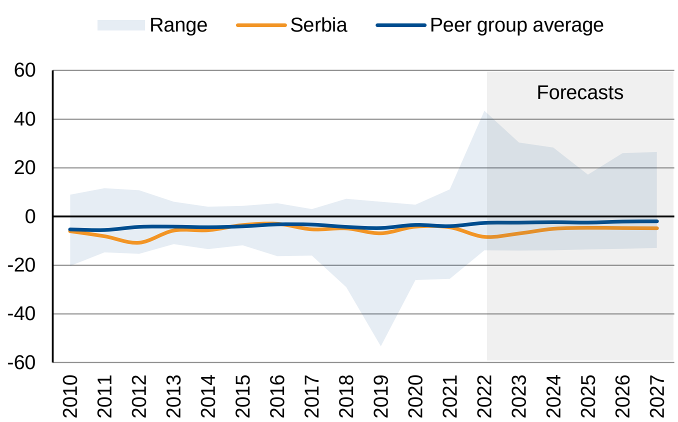
External Economic Risks

- **Current account:** We project Serbia's current account deficit to widen to around 9% of GDP this year, from 4.4% of GDP in 2021, mainly due to the impact of higher energy prices. Our projection of a medium-run current account deficit is 5% of GDP. This reflects 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. The deficit is projected to be financed by FDI in the coming years. Net FDI inflows exceeded the current account deficit in 2015-2021. In January-August of 2022, net FDI inflows reached EUR 2.5bn, almost entirely covering the current account deficit of EUR 2.8bn in the same period. During 2019-2021, most FDI came from EU countries (57%), while China increased its share to 15%.
- **External position:** Serbia's significant net external liability position, which reflects the history of current account deficit, remains a credit weakness. The net international investment position equalled -83% of GDP as of Q2 2022, down from 90% of GDP as of Q2 2020. Around 60% of total external liabilities relate to inward FDI, which decreases the risk of money flight during times of global market distress.
- **Resilience to shocks:** We expect the NBS to remain committed to preserving a stable exchange rate and use currency-market intervention for that. The NBS has adequate FX reserves, and the recent dinar appreciation pressure has helped the NBS to recover some of its foreign-exchange reserves spent earlier in the year in defence of the currency. Gross NBS forex reserves amounted to EUR 16.5bn at end-September, close to the all-time high of EUR 16.8bn in September 2021. The level of NBS forex reserves covers almost five months' worth of Serbia's import of goods and services and more than two times its short-term external debt, which are well above IMF adequacy thresholds of three months' worth of imports and 100% of short-term debt.

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

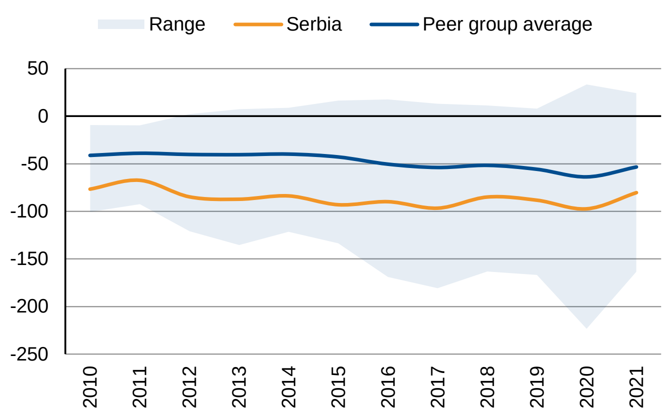
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
cc	Current account resilience	Weak	-1/3	Wide structural current account deficits due to high investment needs with relatively low domestic savings and narrow export base
	External debt structure	Neutral	0	Current account deficits are 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

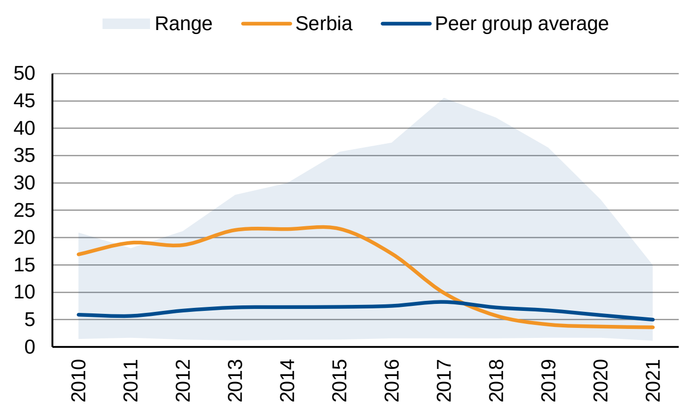
Financial Stability Risks

- **Banking sector:** Serbia's mostly foreign-owned banking sector (over 80% of bank assets is foreign-owned) presents low contingent liability risk to the sovereign balance sheet, including considering the recent completion of acquisition of the largest state-owned bank Komercijalna Banka by Slovenia's NLB Group. The banking sector withstood the pandemic crisis well and remains adequately capitalised and liquid. The sector's direct exposure to Russian banks is limited. The system-wide Tier 1 capital was still high at 18.2% of risk-weighted assets as of Q2 2022. Return on equity recovered to its pre-pandemic levels, at 10.5% as of the same quarter. The NBS' conservative macroprudential tools framework, which is regarded as 'equivalent' to the EU's, supports overall stability in the system.
- **Private debt:** In general, the degree of private sector involvement in the Serbian economy is moderate compared to its 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 growth. Private external debt amounted to 32% of GDP as of Q2 2022, unchanged over the past years. Over 90% of this constitutes medium and long-term debt.
- **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. The non-performing loan ratio continued falling, to 3.3% as of Q2 2022, down 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*

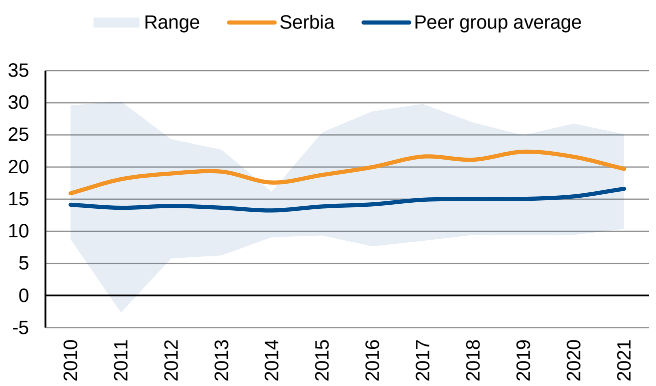
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Mostly foreign-owned, well-capitalised and liquid banking sector; low contingent liability risk to the sovereign balance sheet
	Banking sector oversight	Neutral	0	Conservative banking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

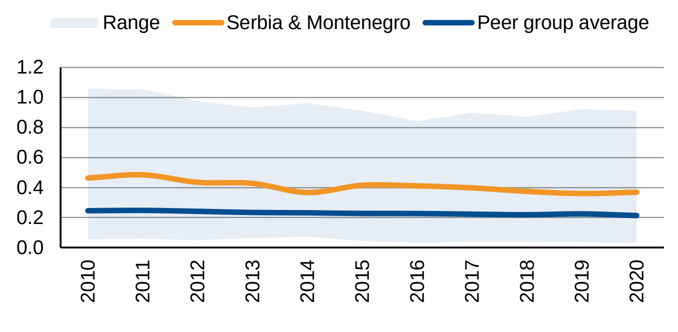
ESG Risks

- **Environment:** Serbia issued its debut green Eurobond of EUR 1bn (offers exceeded EUR 3bn) in September 2021, with a maturity of seven years and a coupon rate of 1.00%, 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. However, Serbia's economy has a high energy intensity, nearly four times that of the EU. Electricity production in Serbia relies heavily on coal (around two-thirds of electricity generated in 2021 came from lignite coal), a key challenge on the way to reduce emissions. Despite strong growth in wind power in recent years, it generated only 2.4% of electricity in 2021. The construction of a gas pipeline between Serbia and Bulgaria, which is planned to be completed by Q4 2023 and financed through a EUR 49.6mn EU grant and a EUR 25mn EIB favourable loan, will allow for the transfer of 1.8 bcm of natural gas annually, equivalent to 60% of Serbia's annual consumption. The pipeline will improve the diversification of energy sources in Serbia, and the stability and security of its gas supply.
- **Social:** Serbia's labour market growth in the longer term is hindered by demographic trends, reflecting an ageing population and emigration, which constrain labour supply. The old-age dependency ratio (those aged 65 years or over as a % of those aged 15-64) is projected by the UN to increase to over 35% by 2030, from 31.6% in 2022. At the same time, there has been some improvement in migration flows, which is attributable to an immigration of 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 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, 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. The fact that Serbia, to date, has not aligned with EU restrictive measures against Russia might further complicate accession talks.

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

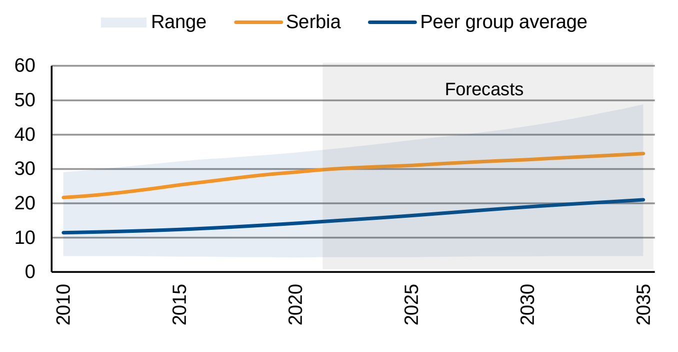
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Environmental risks	Weak	-1/3	Diversification of energy sources via EU funding and green issuances, but elevated energy reliance on coal
	Social risks	Neutral	0	An ageing population and emigration constrain labour supply;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

CO_2 emissions per GDP, $mtCO_2e$



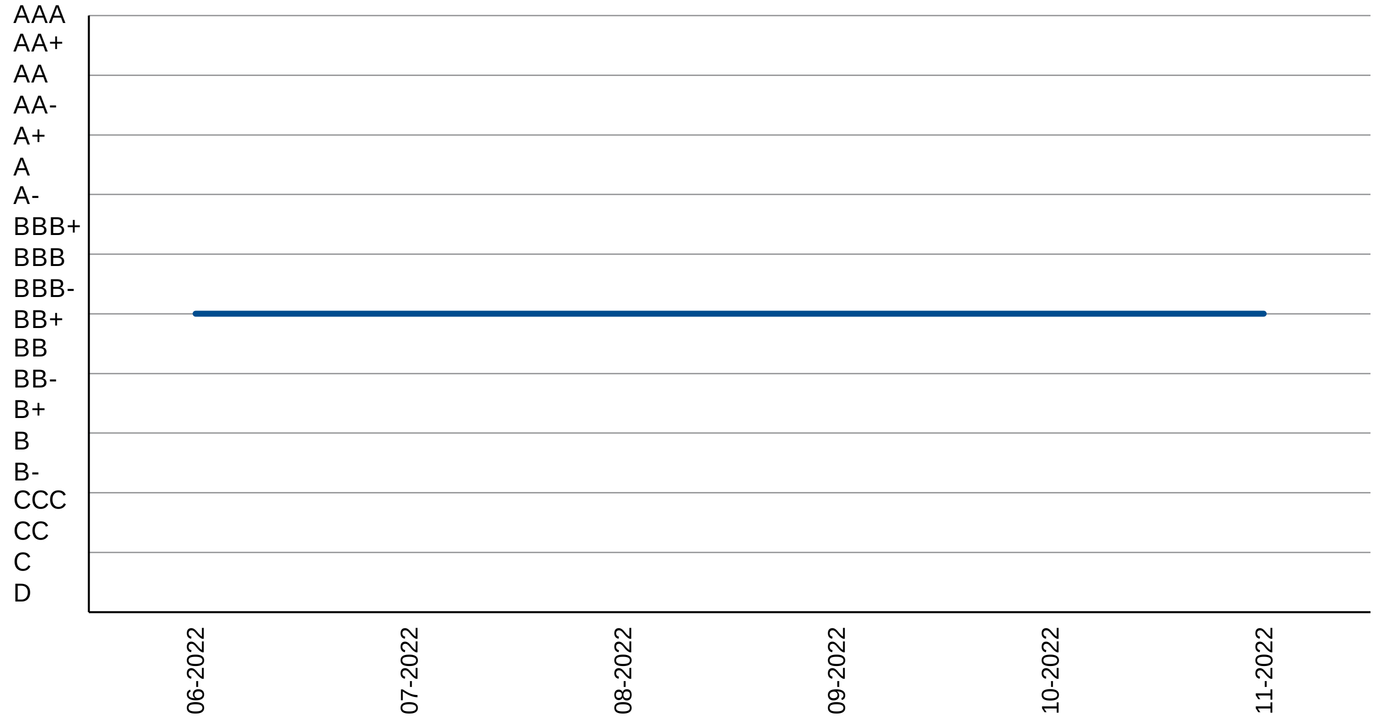
Source: European Commission, Scope Ratings

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
Georgia
Greece
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	2017	2018	2019	2020	2021
Domestic Economic	**GDP per capita, USD**	IMF	6,293	7,252	7,397	7,700	9,178
	Nominal GDP, USD bn	IMF	44.2	50.6	51.5	53.3	63.1
	Real growth, %	IMF	2.1	4.5	4.3	-0.9	7.4
	CPI inflation, %	IMF	3.1	2.0	1.9	1.6	4.1
	Unemployment rate, %	WB	13.5	12.7	10.4	9.0	11.8
Public Finance	**Public debt, % of GDP**	IMF	60.1	55.6	53.6	58.7	57.9
	Interest payment, % of revenue	IMF	6.1	5.2	4.8	4.9	4.0
	Primary balance, % of GDP	IMF	3.9	3.0	2.0	-5.2	-1.6
External Economic	**Current account balance, % of GDP**	IMF	-5.2	-4.8	-6.9	-4.1	-4.4
	Total reserves, months of imports	WB	5.0	4.7	5.2	6.1	5.3
	Net international investment position, % of GDP	IMF	-90.6	-87.5	-88.0	-90.3	-83.1
Financial Stability	**NPL ratio, %**	IMF/NBS	9.8	5.7	4.1	3.7	3.6
	Tier 1, % of RWA	IMF/NBS	21.6	21.1	22.4	21.6	19.7
	Credit to private sector, % of GDP	WB	40.3	41.4	42.0	45.5	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	397.9	374.4	360.1	368.9	232.9
	Income share of bottom 50%, %	WID	16.3	17.8	17.8	17.8	17.8
	Labour-force participation rate, %	IMF	66.7	67.8	68.1	67.7	71.7
	Old-age dependency ratio, %	UN	30.2	30.8	31.4	31.9	31.9
	Composite governance indicators*	WB	0.0	0.0	-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/Developing economy
5y USD CDS spread (bps) as of 18 November 2022	315

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