26 October 2017

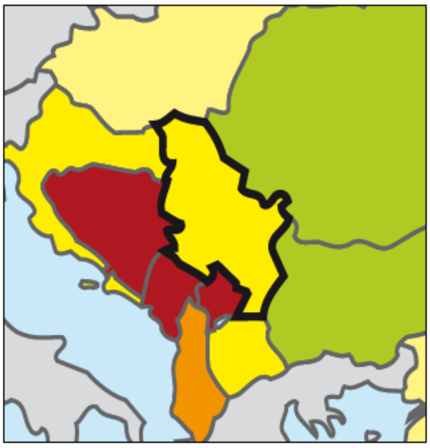
5/7 COUNTRY RISK CATEGORY

COUNTRY RISK ANALYSIS

Serbia

0 1 2 3 4 5 6 7

The country risk categories range from 0 to 7. The lower the number, the better the credit rating of the country.



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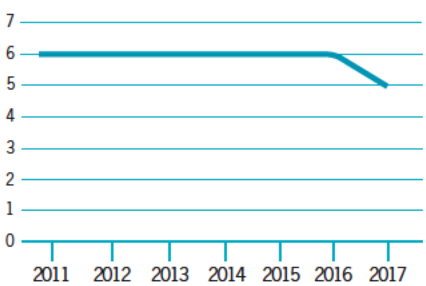
BASIC FACTS

Population	7 million (2016)
GDP, nominal	USD 38 billion (2016)
GDP/capita	USD 5,400 (2016)

COUNTRY CLASSIFICATION HISTORY



Source: EKN

Better growth than expected for this EU candidate country

Economic decline and a lack of reform over the past decade have resulted in substantial budget deficits and a mounting burden of debt for the Serbian state. In 2014 the country was in serious trouble, but was saved by a loan from the IMF. However, the government objective of achieving EU membership as early as 2020 has pushed through reforms in the economy and judicial system. The austerity programme launched in 2015 in conjunction with the renewed IMF agreement has shown results and growth has gathered momentum. Important steps have thus been taken to ensure greater stability in the public finances. One of the several challenges includes a persistently high level of debt, a substantial current account deficit and loss-making public sector companies which burden the country's economy.
In May 2017 the former Prime Minister Aleksandar Vučić was elected President, and in June Ana Brnabić became the new Prime Minister. For this reason current policy is expected to remain considerably the same. However, progress towards EU membership will likely take longer than will the government's planned entry.

EKN places Serbia in country risk category 5 of 7. Normal risk assessment is applied except in the case of other public purchasers. EKN's payment experience is relatively good, but there have been cases of serious delays.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

STRENGTHS

+ The IMF agreement and a start on negotiations regarding EU membership are speeding up reform.
+ The reassurance of international reserves, which are currently the equivalent of five months' import cover.
+ Diversified industry and relatively substantial natural resources may yield significant tax and export revenues should the rate of investment increase.

WEAKNESSES

- A high level of government and external debt as well as a fragile banking sector.
- Cumbersome bureaucracy and inefficient public-sector companies burden the government budget and undermine interest in investment from abroad.
- Small domestic market and export-dependent.

SWEDISH EXPORTS TO SERBIA, MSEK

Serbia	MSEK
2016	1 010
2015	1 076
2014	1 023
2013	909
2012	899

Source: Statistics Sweden

EKN'S EXPOSURE

	MSEK
Guarantees	326
Pledges	19

EKN'S POLICY

As of 2017 EKN has placed Serbia in country risk category 5 of 7. Classification is carried out in collaboration with other OECD countries. EKN applies normal risk assessment for banking risks and pure sovereign risks. In the case of other public purchasers, a letter of credit or bank or sovereign guarantee is required.

EKN'S EXPOSURE AND EXPERIENCE

EKN's outstanding guarantees to Serbia amount to SEK 326 million, and this is a downtrend. These outstanding guarantees consist mainly of transactions in the telecommunication and power sectors, but mining, mechanical engineering and transport industries are also represented. The number of guaranteed transactions is relatively small at an average of just under ten transactions per annum. During the past five-year period EKN experienced a number of delayed payments and damages in Serbia, primarily in the outsourcing, mining and transport sectors. General experience shows that recovery processes through the courts are slow and that the outcome is uncertain. Locally registered securities such as retention of title and pledges have been shown to be crucial in ensuring a quick verdict in court. Enforcing a verdict and withdrawing equipment is complicated and time-consuming. In some cases guarantee holders have also experienced problems taking the recovered monies out of the country, one reason being the extensive bureaucracy of the Serbian Central Bank which has led to delays and obstructions. In contrast, payment experience in the telecommunication sector has been good, and in recent years there has been an overall decrease in the number of cases of delay. EKN's claims on Serbia amount to SEK 73 million, of which 60 per cent are political claims regarding transactions entered into during the '80s and '90s. These claims are governed by a Paris Club agreement that is being followed according to plan. The agreement states that the final repayment will be made in 2024.

WHAT MIGHT CAUSE A CHANGE IN THE COVER POLICY?

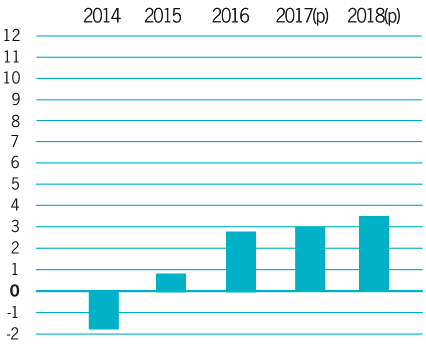
EASING OF RESTRICTIONS, IN THE EVENT OF:

- A reduced budget and current account deficit, a falling level of debt and a stabilised currency.
- A clearly improved business environment and structural reforms.

THE TIGHTENING OF RESTRICTIONS, IN THE EVENT OF:

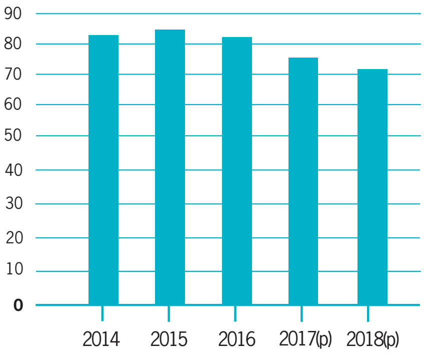
- Stability in the banking sector being threatened by an economic downturn or fall in the Serbian dinar.
- Suspended EU negotiations or unsuccessful economic reform.

GDP GROWTH (% PER ANNUM)



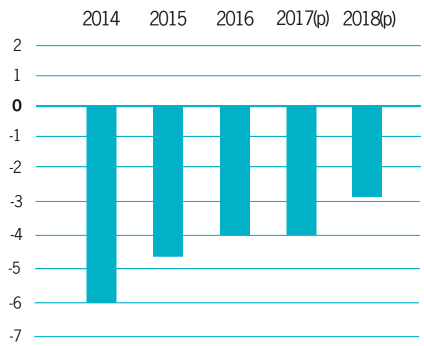
Growth in the economy is better than expected.
Source: IMF WEO 2017

EXTERNAL DEBT (% OF GDP)



The trend in external debt has turned.
Source: IMF 2017

CURRENT ACCOUNT (% OF GDP)



The current account has improved but still shows a substantial deficit.
Source: IMF 2017

COUNTRY ANALYSIS

BACKGROUND

Serbia's long-term economic difficulties stem from the legacy of the economic system in former Yugoslavia and in the nationwide divisions, war and sanctions of the 1990s. The economy is relatively diversified but inefficient. Industry is dated and not competitive. In 2012 the IMF cancelled its support programme for Serbia after the government passed an expansive budget instead of necessary but unpopular budget cuts in order to strengthen public finances. During 2013 and 2014 a new programme of reform was introduced, which was followed by new elections whereby the ruling Serbian Progressive Party (SNS) had its mandate renewed. In the spring of 2014 Serbia was hit by extensive flooding, incurring costs of up to EUR 2 billion as a result. The vital agricultural sector was hard hit, as was electricity production, which sent the economy into recession.

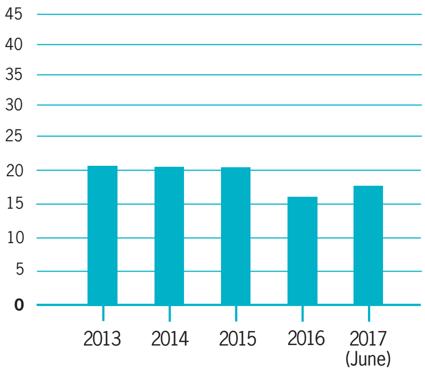
THE MOST RECENT TREND

These past two years, 2016 and 2017, have been more favourable for the country's economy. Growth has once again gathered momentum, and is expected to be three per cent in 2017. The budget deficit was reduced from 6.6 per cent in 2014 to 1.4 per cent in 2016, due primarily to an increase in tax revenues and a reduction in wage and pension costs. Serbia has thus succeeded in combining a tightening of public finances with greater economic growth.

The banking sector has been strengthened during the past two years but is still fragile. Profit levels are on the rise,whilst the previously very high proportion of non-performing loans is simultaneously being reduced. The main reason for this is the loans that have been written off as part of the government's strategy to bring stability to the banking sector. However, given that the average number of non-performing loans is 15 per cent, the quality of access in the banking sector remains low especially in the case of the national banks. The proportion of non-performing loans is lower and falling more rapidly in the case of private banks, since more foreign banks keep books that are of significantly higher quality than the average. Around 70 per cent of non-performing loans in the banking sector have been earmarked, which is in line with the average for Eastern Europe. The degree of capital adequacy shows an overall rising trend, and currently stands at around 22 per cent. There are therefore sufficient buffers in the banking system. The large-scale lending of foreign currency – almost 70 per cent of total lending – constitutes a significant risk in the banking sector and for borrowers. Three quarters of the banking system are foreign-owned, these banks being primarily Austrian, Italian and Greek. In June 2017 the Basel III regulations came into force, which provide a stronger framework than before and should promote stability in the banking system.

In the political sphere, Prime Minister Aleksandar Vučić was recently sworn in as President. While the presidential post is ceremonial in practice, Vučić wields considerable power as leader of the ruling

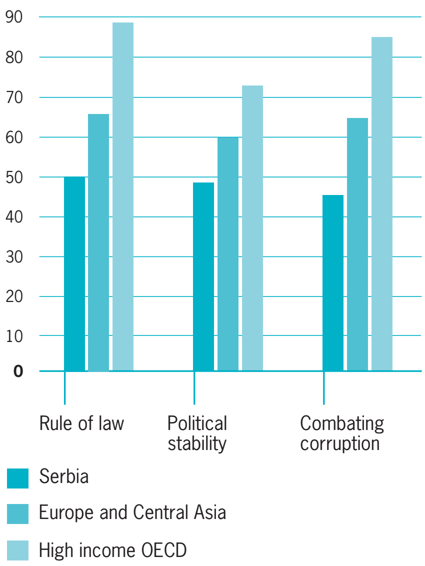
NON-PERFORMING LOANS IN THE BANKING SECTOR (% OF GROSS LOANS)



The quality of access in the banking sector remains low on average.

Source: IMF 2017

BUSINESS ENVIRONMENT



Ranking from 0 (worst) to 100 (best)

Source: The World Bank

party SNS, meaning that he will continue to govern Serbia. The new Prime Minister is Ana Brnabić, who was appointed by the President in June in preference to the other significantly more conservative and pro-Russian candidates. This sends a signal first and foremost to the EU that Serbia continues to seek EU approximation.

THE LONG-TERM TREND

The positive trend seen in recent times means that the prospects for growth appear better. The IMF is counting on a growth rate of 3.5–4.0 per cent per annum during the period 2018–2022. This growth is benefiting from a higher rate of growth in the Eurozone and recovery in the Russian economy, resulting in an increased demand for Serbian export products. Agriculture is important for the Serbian economy, and so is an extensive manufacturing industry and the extraction of relatively large reserves of copper, bauxite, iron ore, oil and gas. Inflation is once again under control, and currently stands at around three per cent at the same time that unemployment is falling. Nevertheless, around 16 per cent of the population of working age are still out of work.

Thanks to budget constraints, current government debt is 70 per cent of the GDP and is estimated to continue falling to 54 per cent of the GDP by 2022. Around 80 per cent of the government debt is in foreign currency, mainly EUR and USD, which means that exchange rate fluctuations strongly impact on interest and debt service charges. Extensive structural reform is still needed in order to improve the government budget, whose expenditure side is weighed down by high subsidies, wages and pensions. Subsidies and unpaid taxes from large loss-making public sector companies cost the state approximately USD 1 million per annum. Public sector companies employ around 250,000 people in the country. The three-year agreement between the IMF and Serbia has had a stabilising effect on the economy in terms of both Serbia's borrowing ability and the role of the IMF as a supervisory authority for the government's programme of reform. The IMF agreement expires in February 2018, which may have a cooling-off effect on investors' risk appetite, the borrowing ability of the country and the pace of essential reform.

Serbia has had a weak current account for many years, which is due to chronic deficits in its trade balance. Since 2014 its trade balance has improved somewhat as remittances have increased, which means a healthier current account. However, the current account is still expected to show a deficit of around four per cent of GDP up to 2022. Foreign direct investment (FDI), mainly on the part of the EU, has increased compared to 2014 and has helped improve the balance of payments. External debt is still high at around 80 per cent of GDP, but thanks to the fall in government debt there is a downward trend. Almost two thirds of the external debt represents public debt.

By 2022 the IMF expects external debt to have risen to 56 per cent of GDP, which is still high. The very high debt service ratio has reduced somewhat over the past two years, thanks in part to a fall in external debt. However, the debt service ratio remains high and represents 25–30 per cent of exports, which constitutes a weakness. The Serbian dinar depreciated by more than 70 per cent against the US dollar during the 2014-2016 period, but has rallied by around 20 per cent since January 2017. An increase in foreign direct investment (FDI) is expected to have a rallying effect on the currency which is to an extent a floating one. Stronger currency means a decreased cost of the external debt. Serbia's international reserves have diminished over the past two years but still represent around five months worth of imports.

Negotiations with the EU on Serbian membership of the EU have had an impact on reform measures in Serbia. Apart from economic reform, there are calls for change within the judicial system and public administration, the fight against corruption, and measures to combat organised crime. Serbia will need to balance its good relations with Russia with closer collaboration with the EU, not least as regards trade agreements. In the field of foreign policy, the EU expects Serbia to establish normal relations with its neighbours, which has a stabilising effect on the Balkan region but risks creating delays in Serbia's negotiations on EU membership. During the past year greater criticism has been voiced regarding Kosovo and Croatia. This is one of several signs that the risk of inter-state conflict has increased in the Balkan region during this past year.

In the field of domestic policy, the constant calling of new elections puts a strain on political continuity and involves significant administrative costs. The appointment of the non-partisan and openly gay Brnabić as the country's first woman prime minister is unusual in conservative Serbia, but is seen by critics as a way of appeasing the EU without requiring its conservative policy to change course. The new Prime Minister has given assurances that she will continue the efforts begun by President Vučić to achieve EU membership by 2020. On the home front, Serbia still has a considerable amount of preparatory work to do at the same time that the EU is presumably reluctant to expand any time soon. Serbian membership of the EU will therefore probably be a drawn out process.

BUSINESS ENVIRONMENT

Serbia has risen high up the World Bank Doing Business Index and is now ranked 47th out of 190 worldwide in terms of corporate climate. This ranking is lower than that for the neighbouring countries of Romania, Bulgaria and Croatia but considerably higher than, say, Bosnia and Herzegovina. In recent years initiatives to bring about improvement have been taken in areas regarding the granting of credit, right of ownership, insolvency and property tax, but this process of change is slow. Despite the removal of a number of formal obstacles, bureaucracy is still burdensome and widespread corruption a problem in export transactions with the country. The country has been ranked 72nd out of 176 in the Transparency International Corruption Perceptions Index, which puts it in the middle of the rankings for the region. Complex tax regulations have created a black market for goods and services.

A large part of the bureaucracy and inefficiencies in the economy are due to extensive government interference. Over the past three years a privatisation programme involving the selling off of a large number of public-sector companies has been implemented, but there are still several large and strategically important companies awaiting privatisation. In 2018 the Komercijalna Banka - which is the country's next largest bank measured in terms of assets - is expected to be privatised. Serbia's closer relations with the EU and IMF point in this direction. Serbia is expected to continue its efforts to improve its corporate climate over the coming years. In carrying out corporate risk assessment, special note should be made about the exchange rate exposure of companies, bearing in mind the risks that exist along with the high levels of leverage in foreign currency and the historically volatile nature of the Serbian dinar.