COUNTRY RISK ANALYSIS

Serbia

CREATING CONFIDENCE IN YOUR EXPORTS

COUNTRY RISK CATEGORY

6/7

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

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES IN THE COUNTRY

Short-term transactions: SEK 4 million

Medium and long-term transactions: SEK 753 million

EKN'S POLICY

Sovereign risks: Normal risk assessment

Other public risks: Restrictive risk assessment

Bank risks: Restrictive risk assessment

Corporate risks: Restrictive risk assessment

See "EKN'S POLICY" section

DATE

20/03/2013

Lack of reforms hurting economic prospects

Serbia's economic recovery after the financial crisis has been sluggish and the growth outlook continues to look weak. The lack of competitiveness in the economy, and the dependence on Europe makes it difficult to reduce vulnerability. A high external debt and large current account deficits are additional weaknesses. The lack of political will to reform the economy has damaged confidence in the economy and increased the need for an additional IMF programme. Serbia still has access to funding both externally and internally, which together with stable foreign exchange reserves reduces the risk of a balance of payments crisis in the short term. Borrowing in foreign currency together with currency depreciation creates credit risk both in the banking and corporate sectors.

STRENGTHS

- The status as a EU candidate could improve the business climate in the longer term
- Adequate international reserves
- The banks' foreign owners have provided support during the crisis years

WEAKNESSES

- Dependent on the EU as an export market
- Weak competitiveness is generating structural deficits in foreign trade
- Large external debt and high debt service ratio

POLITICS

Continued weak pace of reforms is hurting the economy

The victory of the nationalist Tomislav Nikolic in the presidential elections in 2012 and the formation of a coalition government, consisting primarily of nationalists and the Socialist Party signified the end of eight years of dominance of the Democratic Party and its leader Boris Tadić. The election results led to a new political landscape, but the general policy direction in terms of economics and foreign policy is likely to be in line with that of the previous government. This could lead to a continuation in the economic policies that the previous government pursued towards the end of its term.

The past two years have effectively been lost years in terms of political and economic reforms. In 2011, the previous government enforced its populist reforms ahead of the election in 2012, which damaged the public finances. Following the election there was political deadlock for nearly three months before a government was formed. With an economy in recession and high unemployment, it is unlikely that the newly elected government will be prepared to prioritise strong public finances and balanced economic growth. On the contrary, among the first policy decisions the new government took was to limit central bank independence and to push through an expansionary budget. Serbia's budgetary indiscipline led the IMF to suspend its assistance programme to the country in 2012.

EU membership, a long term goal

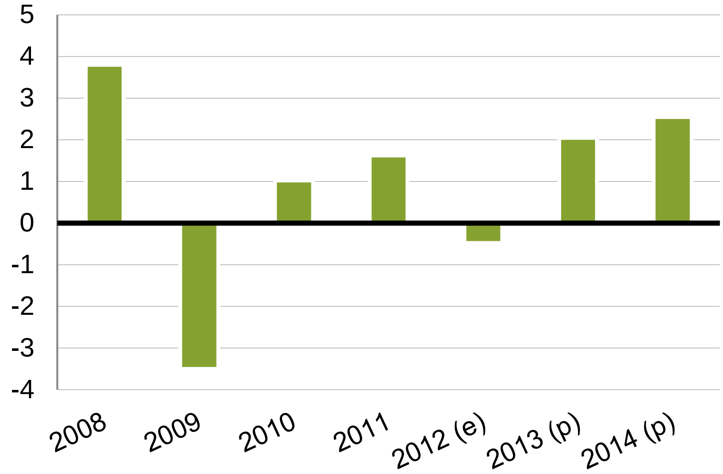
In the longer term, Serbia's EU candidate status is encouraging essential reforms. Kosovo remains a major obstacle in the membership negotiations. EU demands that Serbia respects the territorial integrity of Kosovo, which will take time, not least because of the domestic political debate in Serbia. While EU membership is a goal of the new government, the Serbian electorate is more focused on the immediate economic challenges, particularly the high level of unemployment. The political momentum to bring Serbia closer to the EU could consequently diminish and it is looking increasingly unlikely that the country will join the EU in this decade.

ECONOMY

Renewed recession weakening public finances

Over the past decade, Serbia has undergone a positive institutional shift and established frameworks for the country's economic policies. Serbia has received international support to build up financial institutions in order to improve its resilience to combat economic downturns. However, economic recovery has been sluggish since the global financial crisis in 2008/2009. The main reason has been weak developments in the EU. More than half of exports go to the EU and the export-led recovery has failed to materialise. The restructuring of the industry has been slow. Lack of investment and privatisation is inhibiting productivity and restricting exports. The economy fell into recession in 2012 and the growth forecast for next year is for continued weakness, at around two percent annually.

GDP GROWTH (% PER YEAR)



The financial crisis led the country into recession in 2009 and the subsequent recovery has been weak. Source: IMF

The weak recovery has had a major negative impact on public finances. The budget deficit grew in 2012 which led to a significant rise in the public debt. The privatisation of the economy is slow and unprofitable state owned companies continue to be a burden on public finances. Public finances are also burdened by large pension expenditure and an ageing population. Consequently, the public debt will exceed 60 percent of GDP, which is close to twice what it was in 2008. Given the structure of the budget deficit where current expenditure accounts for more than 90 percent of spending, and with the lack of political accountability, the possibility of reducing the public debt in the medium term is unlikely.

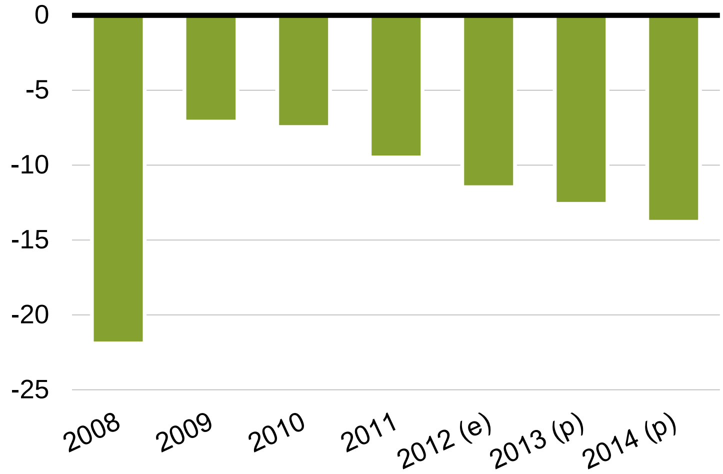
Because of the suspended IMF agreement, the government has been forced to seek funding elsewhere. Loans have been raised both in the international and local capital markets as well as from Russia. A major part of the public debt is financed by domestic funds in the form of short term government bonds, which increases the risk of refinancing. If no new IMF agreement is concluded within the next year, the privatisation of the telecommunications company Telecom Srbija could be a potential source of revenue. The government's continued good access to funding will likely delay the reforms needed to reduce the public sector and improve the business climate. Without a policy anchor from the IMF, there is a risk of the government failing to push through its reforms to improve the flexibility of the economy and reduce the already high level of public spending.

BALANCE OF PAYMENTS AND DEBT ISSUES

International reserves mitigating risks in weak balance of payments

Serbia's external debt and the current account deficit grew significantly in 2012. This deterioration is due to the weak growth combined with chronic trade deficits, with imports almost twice as large as exports. Despite the significant exchange rate depreciation, the situation has not improved, indicating weak competitiveness in the economy. The high level of external debt gives the country a very high debt service ratio. Currency depreciation is increasing the cost of the external debt further and is a concern for the sustainability of the debt.

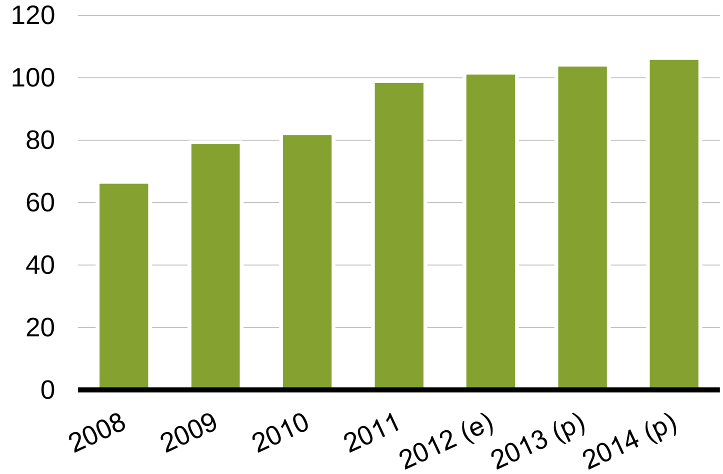
BALANCE OF PAYMENTS (% OF GDP)



Lack of competitiveness is a key reason for the country's large current account deficit. Source: IMF

The negative trend in the current account is being offset by capital inflows for investment in the country. As a result, international reserves are expected to remain at a comfortable level, equivalent to more than six months of import coverage next year. Foreign investment fell in 2012 and capital flowed out of the country through the banking sector, which increased the importance of the international reserves as a buffer. Furthermore, external debt represents 40 percent of the public debt, which is largely financed by international institutions and development banks, which is providing some relief.

EXTERNAL DEBT (% OF GDP)



External debt is rising from an already high level, equivalent to over 100 percent of GDP. Source: IMF and Datastream.

The external debt and debt service ratio will remain high in the coming years. A new IMF programme is needed to break the negative trend and generate stability. Recent negotiations between the government and the IMF will be held in the spring of 2013, and judging by government statements the outlook to bring about an agreement is better than for a long time. Should negotiations fail, Serbia will be more dependent on the domestic credit market and less reliable creditors such as Russia and China. Payment capacity is then likely to be threatened in the long term.

CURRENCY POLICY

Foreign currencies used extensively

The Serbian dinar is floating and has depreciated by about 60 percent since the global financial crisis began in 2008. Serbia has maintained an active exchange rate policy and tried to strengthen the dinar. The widespread use of foreign currency alludes to a lack of confidence in the dinar and is hampering the efforts of the central bank to keep the exchange rate and inflation stable. Besides the highly strained balance of payments, this is also constraining monetary policy as domestic interest rates may not have the same impact when foreign currencies are being widely used.

Despite the central bank's intervention in the currency market, the dinar continued to weaken over the first half of 2012. The causes were the suspended IMF programme as well as the growing budget and current account deficits. Since the second half of 2012, the currency has appreciated which reflects a tighter monetary policy and a slightly improved trade balance. Given Serbia's weak external balance, there is a risk of further depreciation in the short term. The Serbian dinar is not fully convertible, and EKN's possibilities for providing guarantees in local currency have not yet been assessed.

FINANCIAL SECTOR

Developed banking system, clear currency risks

The banking system fared well through the global financial crisis and has undergone extensive privatisation with the help of the World Bank's development programme. Today, three quarters of the banking system are foreign owned. It is principally Austrian, Italian and Greek banks that have established themselves in the market. Privatisation has had a positive impact on liquidity, but the current economic situation in Europe means there is a risk for parts of the support from the European banks disappearing. The agreement that was concluded during the financial crisis in 2009, that the banks in Western Europe would continue lending to their subsidiaries in Eastern Europe, has not been renewed. However, alternative financing has been offered by international financial institutions and the risk of a liquidity crisis is deemed to be negligible.

The large lending in foreign currency, at about 70 percent of total lending, constitutes a risk to the banking sector and borrowers. Deficiencies in the corresponding currency earnings of borrowers means that credit risks in the loan exposure of banks may be greater than first thought. The proportion of non-performing loans has already reached a high level, and the large currency depreciation in recent years could lead to further deterioration. Overall, the Serbian banking system has undergone positive structural development, but in terms of creditworthiness there are obvious currency risks.

BUSINESS ENVIRONMENT

Sluggish improvement of business climate

The World Bank ranks Serbia in 86th place in the world in terms of business climate, worse than most of its neighbours. Despite several initiatives being taken to improve the business climate, there is an extensive administrative and bureaucratic burden which is contributing to widespread corruption. Complicated tax laws have created a huge black market for goods and services. In recent years, initiatives have been taken for improvement in areas regarding the granting of credit, ownership titles, insolvency and property tax, but the process of change is slow. Serbia is generally expected to continue to improve its business climate over the next few years. The accession process to the EU will be a major boost.

The European Commission has called on Serbia to make improvements in the legal field. The recovery environment is weak, which is confirmed by statistics showing the cost and recovery rate for bankruptcies. For corporate risk assessments, special attention should be paid to currency exposure, given the risks associated with high level of lending in foreign currency and a depreciating domestic currency.

EKN'S EXPOSURE

Downward trend in exposure

In 2008-2012, EKN has issued guarantees for 48 transactions totalling SEK 1.3 billion for Swedish companies exporting to Serbia. Both the offers and provision of guarantees have been at a significantly lower level in recent years compared to 2006-08 when major telecom transactions increased the exposure. The outstanding guarantee volume has declined steadily since 2008 and now stands at just under SEK 800 million. Swedish exports to Serbia rose by 6 percent in 2012 compared with the previous year, which may partly explain the rise in EKN's issued offers in recent years. Individual telecom transactions have the greatest importance which forms the bulk of the exposure. Other exposure consists of risks on companies in the infrastructure and mining sectors.

EXPOSURE PER 31 DECEMBER 2012 (MSEK)

Exposure has steadily declined since the peak in 2008.

PAYMENT EXPERIENCE

In recent years EKN has had late payments and claims in Serbia, especially in the construction, mining and transport sectors. The recovery processes are slow and the recoveries made to date are insignificant. However, the payment experience in the telecom sector has been good. EKN's claims against Serbia are mainly political claims with transactions entered into during the 80s and 90s. These total around SEK 55 million and are part of a Paris Club agreement which is being managed according to plan.

EKN'S POLICY

EKN classifies Serbia in country risk category 6, an assessment undertaken in collaboration with the OECD. Between 2007 and 2010, EKN deviated from the OECD classification, as EKN upgraded Serbia to country risk category 6 three years earlier than the OECD.

EKN applies a strict risk assessment for all buyer categories except sovereign risks. For other public buyers additional payment security is required. For banking and corporate risks, EKN particularly takes into account counterparty currency exposure. Adequate financial transparency in the form of complete, audited financial statements is also important for corporate risks.

OFFICIAL COUNTRY DATA AND CREDIT RATINGS

OFFICIAL COUNTRY DATA

Area: 88,400 km² (0.2 times Sweden)

Population: 7.3 million (2012)

Population growth: -0.5 % (2012)

GDP: USD 43 billion in 2011 (Sweden USD 545 billion in 2011)

GDP/capita: USD 5,725 in 2011 (Sweden USD 57,638 in 2012)

CREDIT RATING

	COUNTRY CEILING	SOVEREIGN RATING
Moody's:	-	-
S&P:	BB-	BB-/neg
Fitch:	BB-	BB-/neg

COUNTRY ANALYST

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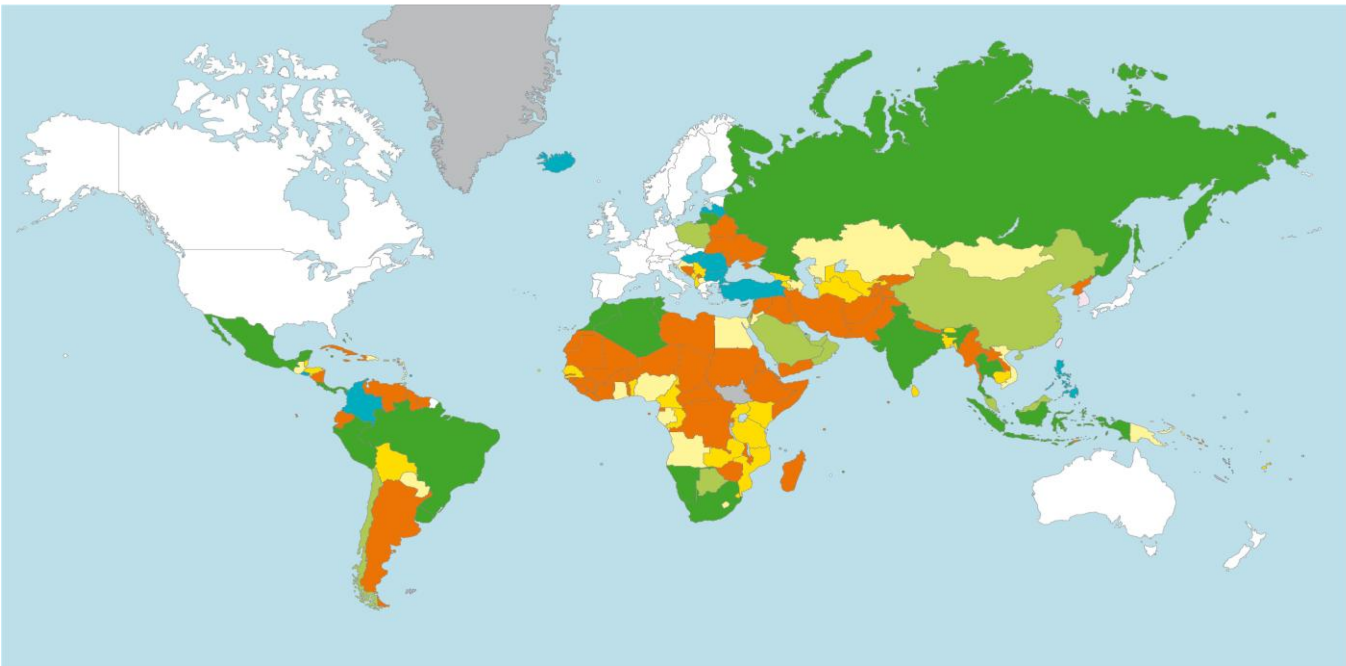
EKN'S VIEW OF THE WORLD



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EKN – CREATING CONFIDENCE IN YOUR EXPORTS
EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management. Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

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