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 1.3 million

Medium and long-term transactions: SEK 556.3 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

13/3/2014

EU negotiations a key step

Serbia is facing a difficult economic situation. The economic decline and the lack of reforms have led to an increase in the budget deficit and higher debt. In January 2014, Serbia began negotiations with the EU on future membership. The path to accession to the union is long, but provides a strong incentive for the government to step up its efforts on structural reforms that need to be implemented, with respect to both the economy and the judiciary. An improved business environment would strengthen the currency and increase investments, which in turn boosts the prospects for growth and creates sounder public finances. It seems that the path has been set out, but it will probably continue to be bumpy.

STRENGTHS

- EU membership negotiations speeding up reforms
- Adequate international reserves
- Relatively rich in natural resources

WEAKNESSES

- Weak competitiveness generating structural deficits in foreign trade
- High debt and debt service ratio
- Difficult business environment lowering interest in investments

POLITICS

Structural reforms needed badly

In 2011, the previous government pushed through its unfinanced expenditure increases in the run-up to the 2012 elections, which damaged public finances. The election results, following the presidential and parliamentary elections in 2012, brought about a change in the political landscape. The Serbian Progressive Party, SNS, won the presidential election and was also able to build a coalition government that included the Socialist Party, SPS. This marked the end of eight years of dominance by the Democratic Party, DS. However, political negotiations within the coalition government did not bring about any major change in policy direction. The economic recession and high unemployment led the newly elected government to push through an expansive budget instead of unpopular budget cuts to strengthen public finances. Serbia's budgetary indiscipline led to the IMF suspending its assistance programme to the country in 2012. In spite of increased cuts in 2013, SNS has had a strong showing in the polls, which led to a warm reception for their announcement of new elections on 16 March 2014. They are hoping to gain a stronger position in the parliament and perhaps their own majority to be able pursue their reform policy. Any other outcome of the elections would risk the reforms being delayed.

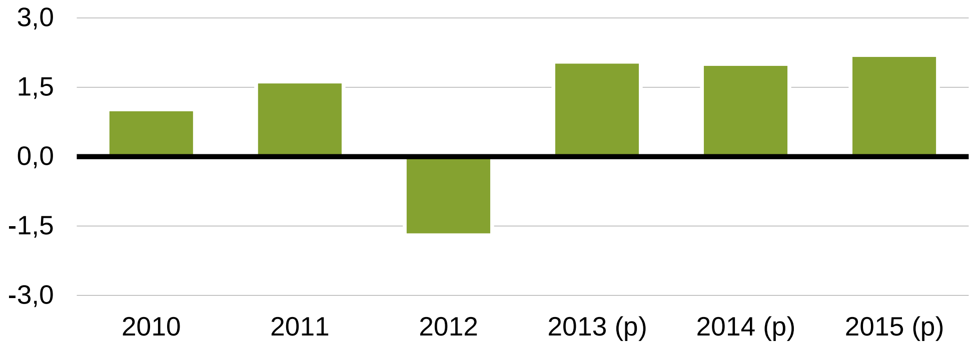
On 21 January 2014, official negotiations with the EU on Serbian EU membership were opened. As a result of the EU negotiations, Serbia needs to pick up the pace of its reform efforts, which is positive. The negotiations are expected to last for several years and crucial requirements imposed on Serbia, apart from economic reforms, are also reforms to the judiciary and public administration, as well as measures to combat corruption and organised crime. Perhaps the largest stumbling block will be the EU's requirement that Serbia establish normal relations with Kosovo, which thus far has led to the membership negotiations being drawn out. The assessment is that the immediate economic challenges together with the EU negotiations are so important for Serbia's government that reforms in the right direction will be implemented, although they will take time.

ECONOMY

Weak growth and deteriorated public finances

Serbia's economic problems are rooted in the national breakup, war and sanctions of the 1990s as well as an aging and non-competitive industry. Parts of the infrastructure and industries destroyed by the NATO bombing in 1999 are still in need of repairs. The forecast for GDP growth in 2014 and 2015 is uncertain and the recovery is affected by the economic trend going forward in the rest of the world. Domestic consumption remains restrained and demand from key trade partners in Europe is weak. Since the state's finances are very strained, there is only a small scope for measures to stimulate growth. The government is rather forced to take strong measures this year to reduce the budget deficit and moderate the increase of the national debt, which in turn has an anti-growth effect.

GDP GROWTH (% PER YEAR)



Growth is expected to recover to a certain extent in the coming years, but with a high risk of growth not reaching the forecast two per cent. Data: IMF

The privatisation of state-owned companies is progressing slowly and unprofitable state-owned companies are a burden on state finances. The lack of political accountability to push through necessary reforms has led to the state's debt gradually increasing over the past years. The debt level is expected to continue increasing, to around 70 per cent of GDP in 2015. The borrowing limit prescribed in Serbia's budget law, which is 45 per cent of GDP, has been exceeded since 2011. Around 80 per cent of the national debt is in foreign currencies, which, together with a weakened currency, adds to the state's problems.

Due to deviations from the agreement with the IMF, Serbia's IMF programme was suspended in the beginning of 2012. The state has been forced to seek financing elsewhere. Loans have been raised both in the international and domestic capital markets as well as from Russia. A major part of the national debt is financed by domestic funds in the form of short government bonds, which increases the refinancing risk. Discussions concerning a new IMF programme are set preliminarily to begin in the spring of 2014. Without a driving force from the IMF, there is a risk of the government failing to push through the reforms needed to reduce the already high level of public spending and get the debt level going in the right direction.

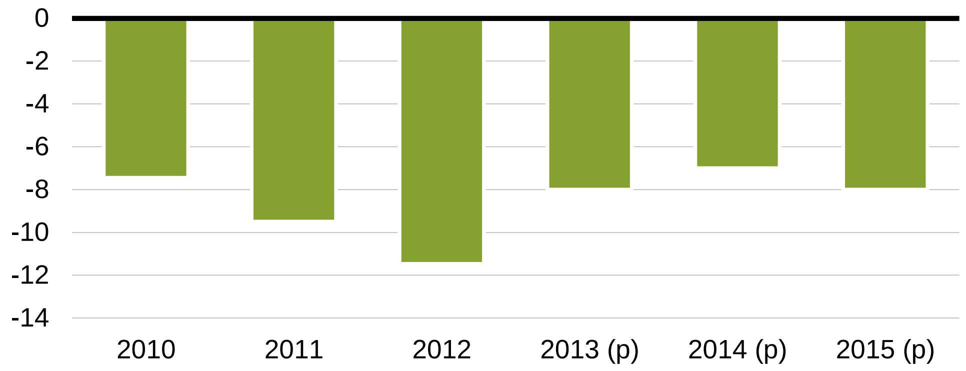
In total, the large budget deficit, low growth and future public cuts with noticeable effects indicate that Serbia is in a tough situation. However, it is probable that efforts to improve the business climate and streamline economic governance will continue, which gives a boost to growth and the public finances in the long term.

BALANCE OF PAYMENTS AND DEBT ISSUES

Weak current account balance is offset by large international reserves

With an economy in recession, Serbia's external debt and current account deficit increased in 2012. The weak current account balance is rooted in the chronic trade deficit, where imports are nearly twice the size of exports. Exports recovered to a certain extent in 2013, mainly in the automotive industry and the agricultural sector. Weaker domestic demand in 2013 brought down imports, which also reduced the current account deficit. The deficit is expected to be between seven and eight per cent for 2014 and 2015. The current account deficit has previously been compensated by capital inflows for investments in the country. Foreign direct investment fell considerably in 2012, which led to an increase in debt. Its high external debt gives Serbia a very high debt service ratio, nearly 40 per cent of exports. The depreciation of the Serbian dinar is increasing the cost of the external debt further and is a concern for the sustainability of the debt.

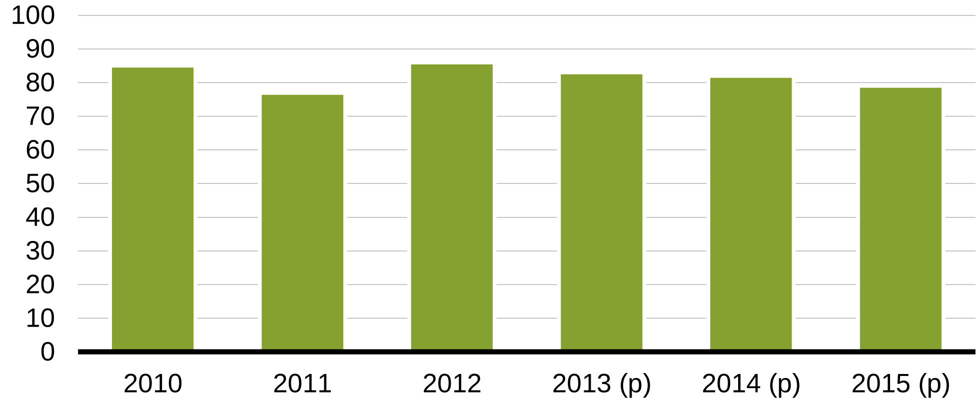
CURRENT ACCOUNT BALANCE (% OF GDP)



A too low proportion of goods exports to imports is the reason for the large current account deficit. Data: IMF.

Serbia's international reserves are at a high level, the highest in the Balkans region, and are equivalent to around six months of imports. Without stabilising measures to boost the country's investment climate and confidence in its currency, the reserves will however gradually decrease.

EXTERNAL DEBT (% OF GDP)



The proportion of debt to GDP is falling slightly. Data: IMF.

The external debt and debt service ratio will remain very high in the coming years. External debt is expected to remain unchanged in absolute terms over the coming years, but, with GDP growth, the debt service ratio will decrease. Together with reform efforts for future EU membership, a new IMF programme would improve the country's debt profile and give a boost to foreign investor confidence. The current reform ambitions increase the likelihood of an IMF programme being put in place this year.

CURRENCY POLICY

Stabilised currency

Serbia has a floating exchange rate for its currency, but the central bank intervenes sporadically to correct the exchange rate. The dinar was stabilised in 2013, at a weak level in comparison to before the 2008 global financial crisis. Since 2009, the central bank has had price stability as its objective. The widespread use of the euro in the country alludes to a lack of confidence in the dinar and is hampering the efforts of the central bank to keep inflation stable. Besides the highly strained balance of payments, this is also constraining monetary policy, as domestic interest rates do not have the same impact when foreign currencies are being widely used. 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

Strong banking sector with currency risks

Three fourths of Serbia’s banking system is foreign owned. It is principally Austrian, Italian and Greek banks that have established themselves in the market. The current economic situation in Europe means there is a risk of parts of the support from the European banks disappearing. However, alternative financing is being offered by international financial institutions and the risk of a liquidity crisis is deemed negligible. The banking system is generally stable, in spite of weaknesses in certain state-owned banks. Weak governance led to the failure of two minor state-owned banks and them being forced into restructuring in 2013. The proportion of bad loans has already reached a high level, and the large currency depreciation in recent years could lead to problems for more borrowers. The rate of capitalisation of the banking system is above both the Basel II minimum requirement and the average for countries with the same credit rating. The liquidity level is slightly below average, but is estimated to be adequate.

The large amount of lending in foreign currencies, around 70 per cent of total lending, is a risk for the banking sector and borrowers, but, according to the central bank, the banks balance their currency positions on the asset and liability side. However, deficiencies in the corresponding currency earnings of borrowers mean that credit risks in the loan exposure of banks may be greater than first thought. Overall, the Serbian banking system has undergone positive structural development, but in terms of credit there are clear currency risks.

BUSINESS ENVIRONMENT

Challenging business climate

The World Bank ranks Serbia in 93rd place in the world in terms of its business climate, worse than the majority of its neighbours, and also a couple places worse than in 2013. Despite several initiatives being taken to improve the business climate, there is an extensive bureaucratic burden, which is also contributing to widespread corruption. Complicated tax laws have created a 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 progressing slowly. Serbia is expected to continue working to improve its business climate in the coming years.

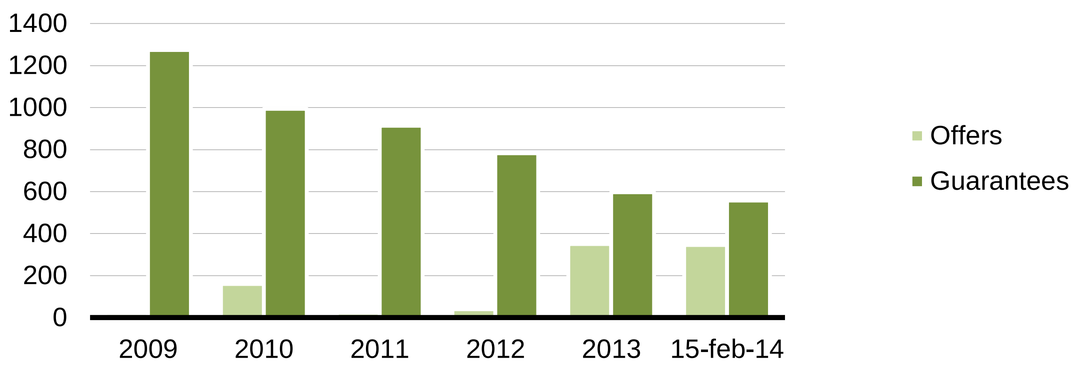
The European Commission has called on Serbia to make improvements to its judiciary. The ability to recover damages is low, in comparison to non-OECD countries in Europe and Central Asia, which is confirmed by statistics showing the cost and recovery rate for bankruptcies. For business risk assessments, special attention should be paid to corporate currency exposure, given the risks associated with a high level of lending in foreign currencies and a depreciating domestic currency.

EKN'S EXPOSURE

Falling guarantee exposure

EKN's exposure in Serbia amounts to SEK 904 million, about 60 per cent of which consists of guarantees and the rest of offers. EKN's guarantee exposure consists mainly of transactions in the telecom sector, but the transport and mining sectors are also represented. The number of guaranteed transactions is relatively low, just under ten transactions per year on average.

EXPOSURE AT 31 DECEMBER (SEK MILLION)



EKN's guarantee exposure has fallen in the past years. Data: EKN

PAYMENT EXPERIENCE

Slow recovery processes

In recent years, EKN has had late payments and claims in Serbia, especially in the construction, mining and transport sectors. Recovery processes via the judiciary are slow and the outcome is uncertain. Locally registered collateral, such as in the form of liens and pledges, has proven decisive for a quick ruling in court. On the other hand, the enforcement of court rulings and repossession of equipment is more complicated and time-consuming. In some cases, guarantee holders have had trouble bringing recovered amounts out of the country. However, the payment experience in the telecom sector has been good.
EKN's claims against Serbia are mainly political receivables with transactions entered into during the 80s and 90s. These total just over SEK 50 million and are part of a Paris Club

agreement which is being managed according to plan. The final repayment is to be made in 2024 according to the agreement.

EKN'S POLICY

Unchanged 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 other OECD countries.

EKN applies a strict risk assessment for all buyer categories except pure sovereign risks. For other public buyers, additional payment collateral 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: 77,500 km² (20% of Sweden's area)

Population: 7.2 million (2012)

Population growth: -0.5 % (2012)

GDP: USD 37.5 billion in 2012 (Sweden USD 524 billion in 2012)

GDP/capita: USD 5,280 in 2012 (Sweden USD 55,041 in 2012)

CREDIT RATINGS

	COUNTRY CEILING	SOVEREIGN RATING
Moody's:	Ba2	B1/stable
S&P:	BB-	BB-/neg
Fitch:	B+	B+/stable

COUNTRY ANALYST

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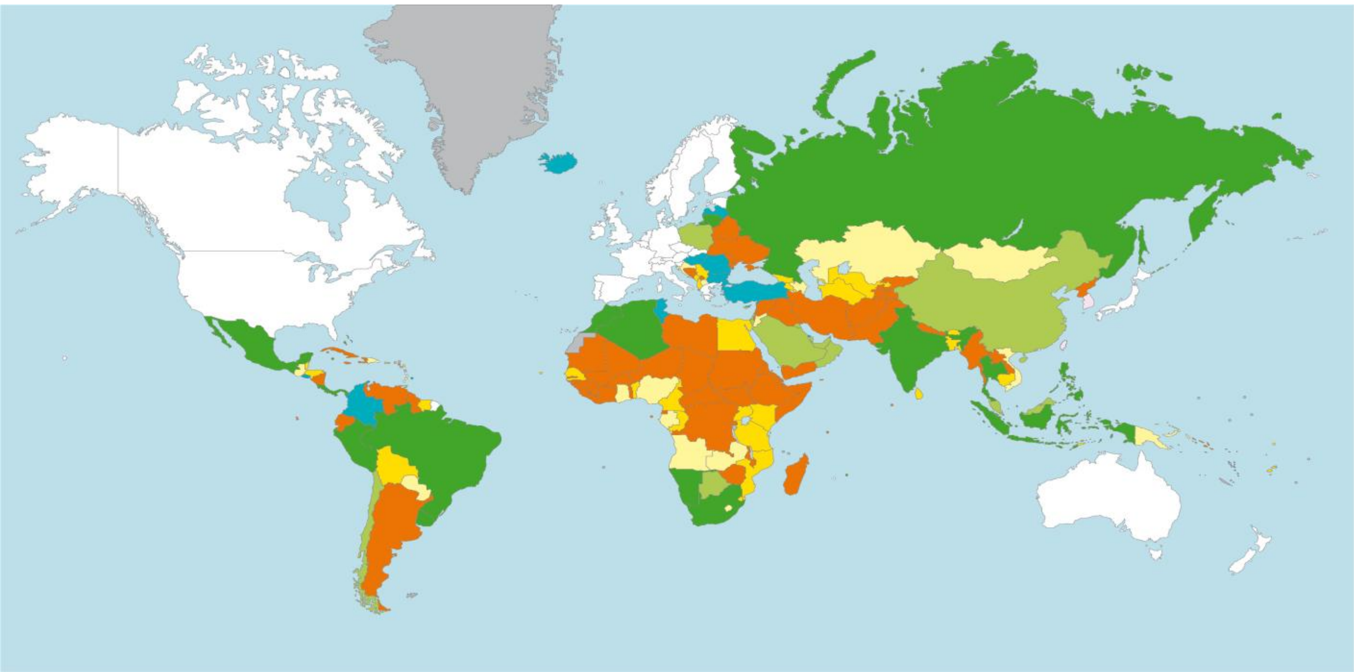
COUNTRY RISK ANALYSIS	DATE	
Serbia	13/3/2014	CREATING CONFIDENCE IN YOUR EXPORTS

EKN'S VIEW OF THE WORLD



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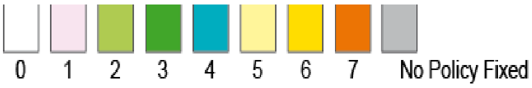

EKN – CREATING CONFIDENCE IN YOUR EXPORTS

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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