

REPUBLIC OF SRPSKA

GOVERNMENT

**REPUBLIC OF SRPSKA DEBT MANAGEMENT STRATEGY
FOR THE PERIOD 2018-2021**

September, 2018

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1. Goals and assumptions

Republic of Srpska Medium-term debt management strategy (RS MTDS) specifies medium term goals and operations within the debt management, that Republic of Srpska Government (RS Government) intends to implement in the medium term in order to achieve desired debt portfolio structure, taking into account cost and risk preferences. Implementation of the RS MTDS is continuously being monitored and reported to the RS Government annually.

The scope of the RS MTDS covers all debt representing direct or indirect obligation of the RS Government - RS budget, with some exceptions.

External debt data includes:

- 1) RS Government debt (except the part of the debt to the Paris Club of creditors-Germany, for which the repayment mechanism has not yet been determined);
- 2) Local governments debt;
- 3) Debt of SOEs and the RS Investment Development Bank (RS IDB).

Domestic debt data includes:

- 1) RS Government debt (verified domestic debt according to the RS Law on domestic debt, debt in the form of treasury bills, bonds, bank loans and activated guarantees) and
- 2) debt of the social security funds contracted indirectly.

Debt (domestic and external) contracted directly by local governments and social security funds is not covered by the MTDS, since it represents neither direct nor indirect obligation for RS (RS budget), hence it cannot be managed by RS Ministry of Finance (RS MoF), on behalf of RS Government. Obligations related to frozen foreign currency savings, war damages and general liabilities are included in the MTDS only if they have been formally verified. Detailed table on the scope of the RS MTDS is presented in Annex I.

The RS debt management goal is to provide financial resources for financing approved investment projects, RS MTDS debt refinancing and RS Budget execution, at minimal costs and risks, while taking into account development of the economy and domestic securities market, as well as debt limits specified in the law.

The RS MTDS is based on the following assumptions:

- 1) In the medium term, the RS Government will continue with implementation of the fiscal consolidation and reform plan, as presented in the RS Economic Reform Programme 2018-2020 (RS ERP 2018-2020), in order to ensure long term fiscal sustainability and transparency (as stipulated by the Fiscal Discipline Law);
- 2) Macroeconomic projections and fiscal framework as presented in the Medium-term Budget Framework Document 2019-2021¹ (MTBFD 2019-2021), shown in Table 1 and 2;
- 3) Any new borrowing on behalf of the RS government will be contracted in accordance with the RS Law on borrowing, debt and guaranties, i.e. through the RS MoF;
- 4) There will be no takeover of debt from other levels of Government;

¹ Medium-term Budget Framework Document 2019-2021 presents detailed assumptions of macroeconomic projections and fiscal framework, as well as associated risks.

- 5) Verification and reconciliation of war damage and frozen foreign currency savings obligations will proceed in accordance with the projections included in the MTBFD 2019-2021;
- 6) Central Bank of Bosnia and Herzegovina (CBBH) will continue to maintain monetary stability in accordance with the Currency Board Arrangement, by the provisions of the Law on Central Bank, and will not be issuing any securities in the domestic financial market;
- 7) Credit rating of Bosnia and Herzegovina will not be downgraded within the medium term²;
- 8) Institutional investor base in the RS domestic financial market will be maintained and broadened in the medium term;
- 9) There will be no significant increase of the European central bank reference rate³;
- 10) Creditors will provide funds at acceptable terms.

Table 1. Review of the macroeconomic indicators for the period 2014-2016, forecast for 2017 and 2018 and projections for the period 2019-2021

	2014	2015	2016	2017	2018	2019	2020	2021
GDP								
GDP nominal, mil.BAM	8.887,3	9.205,0	9.630,6	10.075,7	10.500,3	10.989,6	11.514,9	12.074,5
Population, in mil.	1,2	1,2	1,2	1,2	1,2	1,1	1,1	1,1
GDP per capita, in BAM	7.615,0	7.920,6	8.320,0	8.739,0	9.118,7	8.568,5	10.052,2	10.568,4
GDP growth, nominal (%)	1,1	3,6	4,6	4,6	4,2	4,7	4,8	4,9
Inflation measured by the currency price index (CPI), average annual rate (%)	-1,2	-1,4	-1,2	0,5	1,3	1,1	1,0	1,2
Real growth rates %								
GDP growth, real	0,3	2,8	3,5	3,5	3,7	3,8	4,0	4,0
Import	11,5	0,1	14,9	11,0	10,5	8,5	7,9	7,1
Export	5,7	-4,3	18,8	19,2	16,5	11,8	9,8	9,4
Private consumption	1,6	2,7	2,3	2,0	2,5	2,0	2,1	2,0
Public consumption	2,5	-1,9	2,1	0,2	1,2	0,8	0,9	0,6
Gross investments in fixed assets	4,9	-0,1	3,8	0,5	3,5	3,1	3,7	3,0
Nominal growth rates %								
Average net salaries, in BAM	825,0	831,0	836,0	831,0	840,0	846,0	854,0	861,0
Import of goods, in mil. BAM	4.946,1	4.369,2	4.426,9	4.857,6	5.430,8	5.952,1	6.481,9	7.019,9
Import of goods, annual growth (%)	8,5	-11,7	1,3	9,7	11,8	9,6	8,9	8,3
Export of goods, in mil. BAM	2.692,0	2.613,9	2.869,1	3.476,9	4.095,8	4.624,1	5.123,5	5.666,6
Export of goods, annual growth (%)	3,4	-2,9	9,8	21,2	17,8	12,9	10,8	10,6
Export over Import (%)	54,4	59,8	64,8	71,6	75,4	77,7	79,0	80,7
Unemployment rate (%)	25,7	25,2	24,8	21,0	20,0	19,2	18,6	18,2

Source: MTBFD 2019-2021, RS MoF, RS IoS

² [Actual BH Credit rating](#) is „B/stable outlook“ (Standard and Poors) and „B3/stable outlook“ (Moody's).

³ European Central Bank; [Press Release as of June 14th, 2018](#)

Table 2: Fiscal framework for the period 2018-2021⁴

	Revised Budget 2018	MTBFD 2019	MTBFD 2020	MTBFD 2021
A. BUDGET REVENUES (I+II+III+IV)	2.757,6	2.802,5	2.875,1	2.972,0
I Tax revenues	2.549,6	2.593,4	2.695,0	2.749,0
II Non tax revenues	207,7	208,9	215,9	222,8
III Grants	0,0	0,0	0,0	0,0
IV Transfers among the budgetary units	0,3	0,3	0,3	0,3
B. BUDGET EXPENDITURES (I+II+III)	2.520,9	2.630,1	2.669,4	2.713,3
I Current expenditures	2.367,7	2.438,3	2.468,8	2.497,8
II Transfers among the budgetary units	149,8	175,5	174,7	174,3
III Budget reserve	3,4	16,3	25,9	41,1
C. GROSS BUDGET SURPLUS/DEFICIT (A-B)	236,6	172,4	205,7	258,7
D. NET EXPENDITURES FOR NON FINANCIAL ASSETS	-97,4	-97,8	-96,7	-96,6
E. BUDGET SURPLUS/DEFICIT (C+D)	139,2	74,6	109,0	162,1
F. NET FINANCING (G+H)	-139,2	-74,6	-109,0	-162,1
G. NET PROCEEDS FROM FINANCIAL ASSETS	80,9	59,8	60,4	61,6
H. NET BORROWING	-185,4	-128,1	-163,1	-217,5
I. OTHER NET PROCEEDS	-34,7	-6,3	-6,2	-6,2

Source: MoF RS

2. Existing debt

2.1. Portfolio review

The composition of the RS debt analyzed under the MTDS (RS MTDS debt) is mostly the result of the basic debt management principle implemented in the past, which is maximization of external concessional borrowing. Therefore, the RS MTDS debt portfolio is characterized by a high share of external debt with relatively long maturities and low average implied interest rate of the external debt portfolio at the level of 1,4%.

RS MTDS debt amounts to 4,6 billion BAM (2,8 billion USD) i.e. 45,5% of GDP, as of December 31st, 2017. External MTDS debt accounted for 64,1% of the total (2,9 billion BAM or 1,8 billion USD, i.e. 29,2% of GDP), while domestic debt accounted for 35,9% of the total (1,6 billion BAM or 1,0 billion USD, i.e. 16,4% of GDP).

The external MTDS debt is composed of:

- 1) Relevant external debt, i.e. loans contracted through the BH Ministry of Finance and treasury, as well as allocated „old“ external debt (debt originated before April 2nd, 1992);

⁴ Presented fiscal framework covers the RS budget in the terms of Fund 01 (revenues, expenditures and budget financing).

Relevant external debt outstanding amounted to 2.889,0 million BAM at the end of 2017 (1.771,5 million USD).

2) Direct external debt (debt directly contracted with external creditors).

Direct external debt outstanding amounted to 51,0 million BAM at the end of 2017 (31,3 million USD).

External borrowing is primarily contracted with multilaterals (81,1% of the total external debt outstanding). The largest multilateral creditors are The World Bank - IDA and IBRD (WB), European Investment Bank (EIB), International Monetary Fund (IMF), and European Bank for Reconstruction and Development (EBRD).

Domestic MTDS debt is composed of:

1) T-bills and medium-term T-bonds;

T-bills outstanding amounted to 82,0 million BAM at the end of 2017 (50,3 million USD), with original maturities of 6 and 12 months. Debt outstanding under medium-term T-bonds (4 and 5 year amortization bonds and 3, 5, 7, 10 years bullet bonds) amounted to 852,8 million BAM (522,9 million USD), at the end of 2017.

2) Bonds issued for repayment of debt stipulated by the RS Law on domestic debt:

- i) amortizing war claim bonds with 13-15 year maturity and 3-5 year grace period, and interest rate of 1,5% ;
- ii) amortizing frozen foreign currency savings bonds, with 5 year maturity, no grace period and interest rate of 2,5%;
- iii) amortizing bonds for the settlement of liabilities to suppliers and liabilities under executive court decisions, with a 15 year maturity, 5 year grace period and interest rate of 1,5%.

These bonds are registered at the RS Central Registry of Securities and listed on Banja Luka Stock Exchange. As of end-2017, debt outstanding under these instruments totalled 289,8 million BAM (177,7 million USD).

3) Domestic commercial bank loans;

Debt outstanding under these loans as of end-2017 amounted to 292,3 million BAM (179,2 million USD). These are amortizing loans with fixed or variable interest rate, 3-12 years maturity and 0-3 years grace period.

4) Cash payments (action plans) for reconciliation of obligations under the executive court decisions related to war damage claims and general liabilities, as stipulated by the RS Law on Domestic Debt.

Debt outstanding under this category, as of end-2017, totalled 98,3 million BAM (60,3 million USD).

Obligations for war damage claims, frozen foreign currency savings and general liabilities, which have not yet been verified and therefore do not represent obligation for RS (RS budget), are excluded from the RS MTDS debt portfolio. However, projected repayments of these obligations, based on projected bonds issuances (according to projected dynamics of verification), are included in the expenditures, which influences gross financing needs. Nevertheless, RS is required to recognize these liabilities as debt, in accordance with the existing legal framework. Debt outstanding under these liabilities amounted to 347,0 million BAM (212,8 million USD) at the end of 2017.

2.2. Strategy implementation in 2017 and evaluation of identified debt indicators

Debt management in 2017 was conducted in accordance with the guidelines defined by the Debt Management Strategy for the period 2016-2019, which has been adopted by the Republic of Srpska Government in December 2016.

For the purpose of achieving the main debt management goal, i.e. providing necessary financial resources, in 2017 investment projects were financed mainly from external concessional sources, while budget consumption was financed in the domestic market.

For the second consecutive year, Government faced unavailability of the financial sources for financing the budget consumption, as it was planned by the Debt Management Strategy and Budget for 2017, therefore 48,8% of the financing planned through the external floating instruments was replaced with the domestic fixed instruments and 51,2% of the financing planned through that instrument was not implemented. Total budget financing in 2017 was provided through the domestic fixed instruments. Share of short-term domestic instruments in budget financing in 2017 was 20,3%, while the share in total financing was 13,3%.

Out of the total financing for investment projects in 2017, 96,8% was provided through the fixed instruments (out of which with external instruments 89,3%), 65,8% was denominated in EUR and 7,5% in local currency. In 2017, the possibility of choosing loan conditions at the withdrawal of tranches existed for 6 tranches, withdrawn on the basis of 5 previously approved loans (70,5% of the total external loan funds withdrawn in the same year), where for 5 tranches withdrawn on the basis of 4 loans (representing 95,1% of the withdrawn funds with such possibility) the fixed rate was chosen and amounted to 1,8% in average.

In 2017, three new external loans were adopted by the Republic of Srpska National Assembly, all denominated in EUR, with variable interest rate and the possibility of fixing the interest rate at the withdrawal. These borrowings will influence the debt structure in the future period at the time of withdrawal.

Following table shows debt indicators identified by the Strategy, their target values and evaluation at the end of 2015, 2016 and 2017.

Table 3. Strategy defined indicators of debt structure and their values at the end of 2015, 2016 and 2017

Objective	Indicator	Strategy defined	Values		
			end-2015	end-2016	end-2017
Foreign exchange risk					
	External debt, excluding debt in EUR (% of total)	≤ 35,0	32,6	30,6	26,5
Domestic market development					
	Domestic debt (% of total)	≥ 25,0	32,0	33,4	35,9
Refinancing risk					
	Average time to maturity, in years (ATM) ⁵	≥ 4	6,2	6,3	6,4
	Short term debt - original maturity (% of last year revenues)	≤ 8	5,4	5,5	3,3
Interest rate risk					
	Fixed rate debt (% of total)	≥ 60	62,5	66,0	71,9
Cost of debt					
	Weighted average interest rate, in % (WAIR) ⁶	≤ 3,5	2,3	2,3	2,2

Source: MoF RS

Overall, existing portfolio is associated with low costs. The weighted average interest rate across the total portfolio is 2,2%, while 1,4% for the external debt and 3,6% for the domestic debt. This is mainly the reflection of external concessional loans and low interest rates on bonds issued for reconciliation of domestic debt obligations.

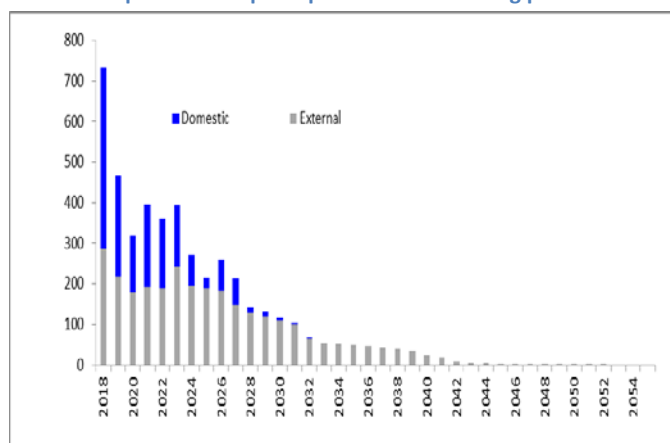
Exchange rate risk is moderate. Out of the total portfolio, 35,9% is denominated in BAM, while 37,5% is denominated in EUR. Under the current currency board arrangement, with BAM pegged to EUR, only 26,5% of the portfolio is exposed to exchange rate risk (or 20,7% after SDR decomposition and excluding the debt in EUR). In USD is denominated 2,5% of the portfolio (or 10,4% after SDR decomposition), which impose some risk, having in mind historical volatility of the USD against the EUR, as well as projections for the future.

⁵ Average time to maturity, ATM

⁶ Weighted average interest rate, WAIR

Refinancing risk is moderate. Fixed rate instruments stand for 71,9% of the total portfolio. Average time to maturity of the portfolio is 6,4 years. Average time to maturity for external debt is 8,0 years, as the result of long-term concessional loans, while average time to maturity for domestic debt is 3,4 years. Redemption profile of existing debt, presented in the Graph 1, shows large amount of repayment of domestic debt (27,1% of total MTDS debt) and external debt (9,7% of total MTDS debt) in 2018, due to the significant amounts coming due on the basis of domestic medium-term T-bonds and commercial loans, as well as IMF Stand by arrangement.

Graph 1. Redemption profile of the existing portfolio



Source: MoF RS

The most important cost and risk indicators of the existing portfolio are shown in the following table.

Table 4: Cost and risk indicators of the existing portfolio

	External debt	Domestic debt	Total debt
Amount (in million BAM)	2.937,4	1.648,2	4.585,6
Amount (in million USD)	1.801,2	1.010,6	2.811,8
Nominal value of debt to GDP (%)	29,2	16,4	45,5
Present value of debt to GDP (%)	22,8	16,4	39,2
Cost of debt			
Interest to GDP (%)	0,4	0,6	1,0
Weighted average interest rate, in % (WAIR)	1,4	3,6	2,2
Refinancing risk			
Average time to maturity, in years (ATM)	8,0	3,4	6,4
Debt maturing in 1 year (% of total)	9,7	27,1	16,0
Debt maturing in 1 year (% of GDP)	2,8	4,4	7,3
Interest rate risk			
Average time to refixing, in years (ATR) ⁷	5,7	3,3	4,8
Debt refixing in 1 year (% of total)	41,1	33,1	38,2
Fixed rate debt (% of total)	61,6	90,4	71,9
Currency risk			
External debt (% of total)			64,1
Short term external debt (% of reserves)			8,1

Source: MoF RS

Maintaining cost and risk indicators at a relatively low level is the challenge for RS, considering the change in the structure of financing sources. The current debt portfolio is characterized by relatively favorable cost and risk indicators, as a result of significant use of the concessional financing sources, as well as bonds issued for reconciliation of domestic debt obligations with a relatively low costs and long maturities. As concessional financing sources are expected to be less available in the future, there will be

⁷ Average time to refixing, ATR

needed more reliance on commercial funds from external and domestic sources, provided that increase in costs and risks is at the acceptable level.

3. Medium term debt management strategy

The main RS debt management goal is to provide financial resources for financing the approved investment projects, RS government debt refinancing and RS budget execution, at minimal costs and risks, while taking into account development of the economy and domestic securities market, as well as debt limits specified in the law.

In order to achieve the main goal, the following goals of borrowing are defined:

- 1) to ensure continuous borrowing opportunities at the domestic financial market and to access international financial market;
- 2) to minimize costs subject to acceptable level of risk, taking into account development of the domestic securities market.

In the following medium term period (2018-2021), the above mentioned goals will be achieved through the *Strategy of Diversifying Financing Sources and Instruments*, which has been chosen as preferred strategy among four analyzed medium term debt strategies⁸. This strategy ensures low costs with acceptable level of risk, reflecting continued utilization of the available support from multilateral creditors, while at the same time improving the RS position in the context of future financing sources, through the domestic financial market development and accessing international capital market for the first time. At the end of observed period, comparing to end-2017, solvency indicators (nominal and present value of debt as a share of GDP), as well as liquidity indicators (debt maturing in 1 year as a share of total and share of GDP, service of interest as a share of GDP) are improved, refinancing risk of domestic debt (measured by average time to maturity) is decreased, as well as interest rate risk (measured by debt refixing in 1 year as a share of total, fixed rate debt as a share of total) and exchange rate risk (measured by short term external debt as % of reserves, as well as nominal amount of external debt, excluding part in EUR, as a share of total).

During the strategy implementation, all borrowing activities will be performed in accordance with the following best practice principles:

- 1) activities at the domestic and international financial market will be performed professionally, transparently, expediently and in a timely manner, while contracted obligations will be fulfilled in the due time and amount;
- 2) selection of the borrowing conditions will be (in priority order) focused at government debt refinancing, providing funds for financing the budget execution, compliance with the debt covenants set in the Fiscal discipline law and achievement of the identified debt indicators;
- 3) when planning borrowing activities, attention will not be focused on the comparative short term advantages of each specific borrowing transaction, but rather on the development and enhancement of long term borrowing opportunities in financial market;

⁸ More details can be found in Annex 2.

- 4) in general, the most favorable borrowing terms and conditions will be ensured, while taking into account principle under 3).

In order to implement the preferred strategy, following basic tasks of the RS MoF have been set out:

- 1) developing and maintaining relations with partners and investors at the domestic and international market;
- 2) designing and, if necessary, revising medium term Borrowing Plan and Auctions calendar based on the cash flow, in order to ensure stable model of total budget inflows on monthly basis;
- 3) publishing auction calendar on the quarterly basis and, whenever possible, providing information on planned issuances for a longer time period;
- 4) continuously maintaining the offer of medium term financial instruments at the domestic financial market, ensuring that instruments and procedures are efficient and favourable for primary trading in order to facilitate the development of domestic securities market;
- 5) identifying the specific debt indicators - maturity profile, interest rate structure, cost of borrowing, domestic debt outstanding, currency risk exposure (excluding the debt in EUR, considering currency board arrangement) and specifying targets for cost and risk indicators;
- 6) debt portfolio monitoring in relation to identified debt indicators and reporting on their values on an annual basis.

In the medium term, the RS MoF task will be to analyze opportunities and harmonize practices and procedures related to domestic securities market with those of EU, if it's feasible in the given time.

In accordance with the defined objectives and basic principles of debt management, considering RS MTDS debt composition and situation at the financial markets, previously defined parameters of the RS MTDS debt portfolio structure and their values will not be changed, as shown in the table 3.

Annex 1. Scope of the RS MTDS

		Included (✓) / Excluded (X)	Reasoning behind including into MTDS	Amounts as of 12/31/2017 mil. BAM mil. USD	
1	Total debt by the Law (1.1.+1.2.+2.a.)		100,0%	5.315,0	3.259,1
1.1.	External debt		55,8%	2.965,4	1.818,4
1.1.1.	Republika Srpska			1.748,9	1.072,4
1.1.1.1.	"Relevant" external debt	✓	Direct liability with with clear repayment obligation	1.736,0	1.064,5
1.1.1.2.	"Relevant external debt" - Paris Club Germany	X	Direct liability with repayment method not defined yet	9,1	5,6
1.1.1.3.	Direct external debt	✓	Direct liability with with clear repayment obligation	3,8	2,4
1.1.2.	Local governments			110,2	67,6
1.1.2.1.	"Relevant" external debt	✓	Indirect liability with clear repayment obligation	93,9	57,6
1.1.2.2.	Direct external debt	X	Neither direct nor indirect liability	16,3	10,0
1.1.3.	SOEs and Investment Development Bank			1.106,3	678,4
1.1.3.1.	"Relevant" external debt	✓	Indirect liability with clear repayment obligation	1.059,1	649,4
1.1.3.2.	Direct external debt	✓	Indirect liability with clear repayment obligation	47,1	28,9
1.2.	Domestic debt		44,1%	2.345,9	1.438,5
1.2.1.	Republika Srpska			1.886,1	1.156,5
1.2.1.1.	Projected domestic debt			768,6	471,3
1.2.1.1.1.	Issued bonds (frozen foreign currency savings, war claims, suppliers, executive court decisions)	✓	Direct liability with with clear repayment obligation	289,8	177,7
1.2.1.1.2.	Planned bond issuances (war claim bonds)	✓	Direct liability with with clear repayment obligation	33,5	20,6
1.2.1.1.3.	Planned bond issuances (frozen foreign currency savings, war claims, general liabilities)	X	Direct liability depending on the verification process	314,2	192,7
1.2.1.1.4.	Cash payments (general liabilities, war claims, frozen foreign currency savings)	✓	Direct liability with with clear repayment obligation	98,3	60,3
1.2.1.1.5.	Planned cash payments (general liabilities, war claims, frozen foreign currency savings)	X	Direct liability depending on the verification process	32,8	20,1
1.2.1.2.	T-bonds	✓	Direct liability with with clear repayment obligation	852,8	522,9
1.2.1.3.	T-bills	✓	Direct liability with with clear repayment obligation	82,0	50,3
1.2.1.4.	Commercial bank loans	✓	Direct liability with with clear repayment obligation	182,7	112,0
1.2.2.	Local governments	X	Neither direct nor indirect liability	294,0	180,3
1.2.3.	Social security funds			165,8	101,7
1.2.3.1.	Direct debt	X	Neither direct nor indirect liability	59,9	36,7
1.2.3.2.	Indirect debt	✓	Indirect liability with clear repayment obligation	105,9	65,0
2	Guaranties (a+б+ц)			317,0	194,4
a	Activated RS guaranties	✓	Called guaranties included in debt	3,7	2,3
б	Non activated RS guaranties	X	Guaranties yet to be called	313,3	192,1
ц	Implicit RS guaranties	X	Debt of SOEs and municipalities and other forms of implicit guaranties	0,0	0,0
3	Total debt included in MTDS		86,3%	4.588,6	2.813,7
4	Total debt excluded from MTDS		13,7%	726,4	445,4

Source: MoF RS

Annex 2. Analytical underpinnings

This section presents scenario analysis, description of alternative borrowing strategies for the RS and consideration of their costs and risks. Debt service projections are generated for each strategy under the baseline and alternative scenarios, applying interest rate and exchange rate shocks. Costs are calculated based on the debt service profile generated under the baseline scenario, while risk is measured as debt service increase due to the interest rate and exchange rate shocks applied.

I. Scenario analysis

For the purpose of sensitivity analysis of the strategies, following shocks are applied:

- **Exchange rate shock:** 30% depreciation against USD in the second year of the observed period, comparing to the initial exchange rate projection for the same year;
- **Interest rate shock:** comparing to the baseline scenario, it has been applied 4% increase in interest rate for long term domestic and long term external instruments and 2% increase in interest rate for short term domestic instruments, which contributes to the flattening of the yield curve;
- **Combined shock:** comparing to initial projection, it has been applied 20% depreciation against USD, combined with 2% interest rate shock for long term domestic and long term external instruments and 1% interest rate shock for short term domestic instruments.

II. Description of analyzed strategies

The analysis shows rigidities of the financing options. Structure of financing budget expenditures in the current year (defined by the RS revised budget), as well as structure of financing the approved investment projects (based on the latest data provided by the project implementation units for the period 2018-2021), is the same in all the observed strategies. The instruments for financing those needs are predetermined. Besides that, all the strategies include the same dynamics of verification and reconciliation of domestic debt obligations (defined by the Law on domestic debt). Variations in strategies relate primarily to the sources of financing budget expenditures (including refinancing needs) in the next 3 years (2019-2021) - 37% of the total financing needs over the projection period (2018-2021).

Available options for RS are limited. After a long period of using solely the concessional multilateral and bilateral financing, that sources are now becoming less available due to the level of development, hence they are used mostly for financing investment projects. Therefore, there is a need for diversification of the financing sources, having in mind limitations of the domestic market (shallow and undeveloped) and international market (country credit rating, relatively modest financing needs which may increase costs and constrain possibilities for bond issuances).

The following strategies were considered:

- **Strategy 1 - Status quo.** Under this strategy, the existing structure of financing budget expenditures in the current year is maintained across the period.
- **Strategy 2 - Continuous presence in the international capital market.** Financing needs are met exclusively through issuing Eurobonds or similar external commercial instruments, which, due to the limitations such as country credit rating and relatively modest financing needs, can lead to the increased costs. Domestic instruments, as well as external concessional instruments, are not used in this strategy.
- **Strategy 3 - Diversifying financing sources and instruments.** Share of external financing is decreasing during the period, in favor of domestic financing. Investment projects are financed

from the external sources, as a result of maximized exploitation of concessional financing sources (WB, EIB, EBRD, CEB, etc.), contributing to the reduction of refinancing risk and cost. In the first year, budget expenditures are financed both from external (IMF, WB, eurobonds), and domestic sources, while in the following years share of financing through medium term domestic instruments is gradually increased, making it the only form of financing by the end of period. Using external financing sources, concessional and commercial, as well as issuing domestic medium term bonds with bullet repayment, contributes to the decrease of refinancing risk and interest rate risk (having in mind that those are mainly fixed instruments), with acceptable level of costs.

- **Strategy 4 - Intensifying domestic market development.** This strategy implies absence of the support from multilateral creditors and external financing sources for budget financing, which requires reliance on the domestic market exclusively. Scope of instruments in the domestic market is increased, with domestic portfolio shifting towards long term instruments, which can lead to the price increase of instruments used, due to the constraints existing in the domestic banking sector (exposure to the public sector, internal policies of limiting the maturities for placements in public sector securities, etc.).

Table 5: Structure of financing instruments in the observed strategies

Instruments for new financing	S1	S2	S3	S4
External Var USD	0,0%	0,0%	0,0%	0,0%
External Var EUR	17,0%	11,6%	13,0%	11,5%
External Fix USD	10,4%	10,4%	10,5%	10,4%
External Fix EUR	19,0%	19,0%	19,2%	18,9%
IMF Var USD	5,5%	2,3%	6,8%	2,3%
Eurobonds	36,9%	52,0%	15,6%	15,3%
Commercial bank loans 5 y Fix DX	11,2%	4,7%	4,7%	4,7%
T-bills Fix DX	0,0%	0,0%	0,0%	2,2%
T-bonds 3y Fix DX	0,0%	0,0%	0,0%	2,2%
T-bonds 5y Fix DX	0,0%	0,0%	9,1%	3,8%
T-bonds 7y Fix DX	0,0%	0,0%	12,5%	15,9%
T-bonds 10y Fix DX	0,0%	0,0%	8,5%	13,0%
External	89%	95%	54%	58%
Domestic	11%	5%	35%	42%

Source: MoF RS

I. Costs and risks of the observed strategies

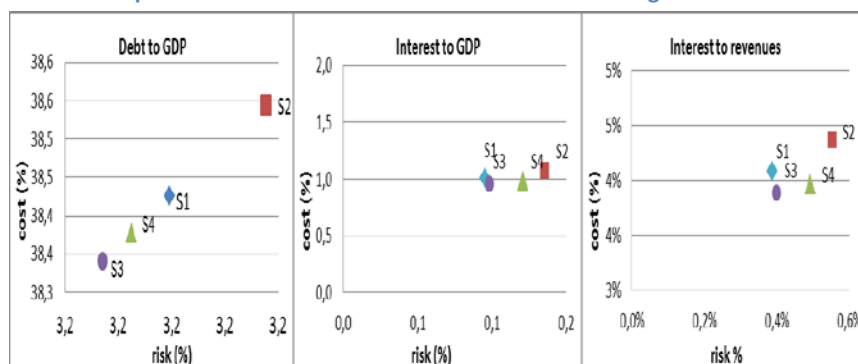
The performance of the selected four strategies was assessed under the baseline and alternative scenarios, with applied shocks. Key cost indicators were calculated to determine how the strategies respond to a set of shocks. The debt/GDP ratio is important when analyzing those changes in the debt stock resulting from

exchange rate movements, since that ratio reflects valuation effects. Interest payments to GDP and to revenues show the potential impact of each strategy on the RS budget. For a given financing strategy, the risk represents the difference between costs under the baseline scenario

comparing to risk scenario

(after applying certain shocks to the baseline). The maximum risk deriving from the three stress scenarios is used to compare the risk associated with each of the borrowing strategies. For comparison purposes, the focus is on the outcome at the end of the time horizon, i.e. 2021. Standard cost and risk indicators for the four strategies are shown in the Chart 2 and Table 6.

Graph 2. Cost and risk indicators of the observed strategies



Source: MoF RS

Table 6: Cost and risk indicators at the end of 2015, 2016 and 2017, as well as indicators of the observed strategies at the end of 2021

	2015	2016	2017	S1	S2	S3	S4
Debt/GDP (%)	48,3	49,8	45,5	38,4	38,5	38,3	38,4
Debt PV/GDP (%)	41,1	42,4	39,2	33,3	33,8	33,4	33,6
Cost of borrowing							
Interest/GDP (%)	1,1	1,2	1,0	1,0	1,1	1,0	1,0
Weighted average interest rate, in % (WAIR)	2,2	2,3	2,2	2,5	2,7	2,4	2,4
Refinancing risk							
Debt maturing in 1 year (% of total)	12,1	13,7	16,0	8,7	8,2	8,3	9,0
Debt maturing in 1 year (% of GDP)	5,8	6,8	7,3	3,4	3,2	3,2	3,5
Average time to maturity for external debt, in years (ATM)	7,6	7,8	8,0	6,7	6,3	7,0	7,0
Average time to maturity for domestic debt, in years (ATM)	3,2	3,4	3,4	2,4	2,5	4,0	4,3
Average time to maturity for total debt, in years (ATM)	6,1	6,3	6,4	6,0	5,8	6,2	6,2
Interest rate risk							
Average time to refixing, in years (ATR)	4,1	4,6	4,8	4,4	4,6	4,8	5,0
Debt refixing in 1 year (% of total)	45,4	42,0	38,2	31,0	26,5	29,2	27,4
Fixed rate debt (% of total)	62,5	66,0	71,9	76,1	80,0	77,4	79,9
Currency risk							
External debt (% of total)	68,0	66,6	64,1	83,2	85,9	72,5	69,9
External debt, excluding debt in EUR (% of total)	32,6	30,6	26,5	23,0	21,6	23,6	21,7
Short term external debt (as % of reserves)	7,4	9,2	8,1	4,5	4,5	4,5	4,5

Source: MoF RS

In terms of interest rate costs and stock of debt, Strategies 3 and 4 bear the lowest cost, Strategy 1 shows slightly higher costs, while the highest cost is shown under Strategy 2. Costs are the highest under Strategy 2, i.e. Strategy 1, based on the complete i.e. increased reliance on more expensive external financing sources. The higher share of external concessional and domestic medium term sources under Strategy 3, as well as domestic short term and medium term sources under Strategy 4, reduces overall costs and therefore also risks (refinancing and refixing risk). The present value of debt is the lowest under Strategy 1 and 3, due to the increased utilization of external concessional instruments, comparing to other two strategies. On the other hand, Strategy 3 bears slightly higher currency risk than other strategies, due to the greater share of external instruments that are exposed to exchange rate fluctuations.

Refinancing risk is the lowest under Strategy 3 and 4, refixing risk is the lowest under Strategy 4 and 2, while the worst results in terms of those risks are shown under Strategy 1. Strategy 4 provides the longest average time to maturity for the domestic, external and total debt, due to the higher share of domestic fixed instruments with longer maturities, as well as reduced utilization of external flexible instruments and those with shorter maturities, comparing to other analyzed strategies. Average time to maturity (for domestic, external and total debt) decreases significantly under Strategies 1 and 2, comparing to Strategies 3 and 4, due to the reliance on relatively short term Eurobonds (in Strategy 2) and issuing domestic instruments with shorter maturities (in Strategy 1). Average time to refixing is the longest under Strategy 4, slightly shorter under Strategy 3, and significantly decreased under Strategy 1 and 2, as a reflection of higher share of external flexible instruments and domestic fixed instruments with shorter maturities (in Strategy 1), as well as external fixed instruments with shorter maturities (in Strategy 1 and 2).

Certain strategies imply significant increase in currency risk. Comparing to portfolio in 2017, at the end of 2021 share of debt denominated in foreign currencies is increasing significantly under all the observed strategies. This is a reflection of strategy objectives in terms of moving towards increased use of external financing sources (in strategies 1 and 2), as well as higher growth rate of external debt comparing to growth rate of total debt (in strategies 3 and 4). It is important to note, however, that actual currency risk is softened by the currency board arrangement, which implies fixed exchange rate of the local currency against the Euro, as well as the fact that currency risk, measured by the share of external non EUR debt in total debt, is lower at the end of 2021, comparing to the portfolio in 2017, under all strategies.

Based on all the considerations given, Strategy 3 is the chosen strategy for the upcoming period. Comparing to other strategies, this Strategy ensures relatively low costs and acceptable risks, due to the available support from multilateral creditors. At the same time, the strategy provides good position for RS in terms of potential future funding sources, through supporting domestic market development and access to the international capital market. Under this strategy, financing costs are the lowest, as well as debt maturing in 1 year as % of GDP. Average time to maturity for domestic, external and total debt, as well as average time to refixing and currency risk, is at the acceptable level. Redemption profile is similar to other strategies, with a peak in 2023, as a result of significant obligations coming due on the basis of Eurobonds issuance.