# FITCH AFFIRMS SERBIA AT 'BB'; OUTLOOK STABLE

Fitch Ratings-London-03 May 2019: Fitch Ratings has affirmed Serbia's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BB'. The Outlook is Stable.

A full list of rating actions is at the end of this rating action commentary.

## KEY RATING DRIVERS

Serbia's 'BB' rating reflects governance and human development indicators that compare favourably with the peer group medians, and the IMF Policy-Coordination Instrument (PCI) provides a near-term policy anchor for further strengthening of macroeconomic fundamentals and reduction in public debt. Set against these factors are Serbia's lower GDP growth potential, higher public debt, greater share of foreign-currency denominated debt, and higher net external debt relative to the peer medians. The current account deficit, at 5.2% of GDP, is also wider than the 'BB' median of 2.3% (partly reflecting a low savings rate of 13.2% of GDP) although it has been fully covered by strong FDI flows in recent years.

Fitch forecasts a moderation in GDP growth this year to 3.1%, from 4.3% in 2018 due to a slowdown in key trading partners, and the absence of one-off factors that contributed to last year's rebound in activity. Domestic demand, including strong investment growth, remains the driver, supported by employment growth (up 2.4% yoy in March), higher wage growth (partly due to this year's 8.6% minimum wage hike), strong FDI flows, more favourable credit conditions, and a slight fiscal loosening. Weaker external demand will weigh on growth, notably from Germany and Italy, Serbia's two largest export markets. We forecast GDP growth of 3.0% in 2020, as softer employment growth is compensated by some recovery in external demand. GDP growth has averaged 2.0% over the last five years, compared with the 'BB' median of 4.2%, and unfavourable demographics and weak total factor productivity growth contribute to Serbia's lower growth potential.

There has been a consolidation of the improved macroeconomic performance of recent years, underpinned by the IMF PCI (in place since July 2018 and which followed the 2015-2018 IMF Standby Arrangement). Inflation expectations remain well anchored and the main policy rate has been unchanged at 3.0% since April last year. HICP inflation edged up to an average 2.4% in 1Q19, from 2.0% in 4Q18, and we forecast a moderate rise to the National Bank of Serbia (NBS) central inflation target of 3.0% towards end-2020. The RSD/EUR exchange rate has largely been flat this year, as it was in 2018. Net FX purchase by the NBS have been around EUR0.1 billion this year, compared with the EUR1.6 billion last year that helped stem appreciation pressures (from higher portfolio inflows and the improved macroeconomic environment).

Fitch forecasts a 0.4pp worsening of the general government balance in each of the next two years, to 0.2% of GDP in 2019 and -0.2% in 2020. This is within the government's fiscal target of -0.5% of GDP for both years, and compares favourably with the 'BB' current median of a 2.7% deficit. The moderate fiscal loosening is driven by somewhat greater expenditure on capital investment, wage and pensions, and a reduction in employer social security contributions. It follows a large fiscal consolidation effort since 2014, when the general government deficit was 6.2% of GDP (including a

reduction in spending on wages and pensions of 3.5% of GDP and in debt interest costs of 0.7%). There is less certainty about fiscal policy beyond 2020 when the IMF PCI expires, but we consider the risk of a more marked loosening is mitigated by the relatively high political priority the government continues to attach to fiscal discipline.

General government debt is on a downward path, which we forecast at 48.8% in 2020 from 54.5% in 2018 (and a peak of 71.2% in 2015) but this still compares unfavourably with the projected 'BB' median of 43.7%. We do not incorporate any stock-flow adjustments, for example proceeds from the privatisations planned under the IMF programme. Under our longer-term debt projections, which assume average GDP growth of 2.8% from 2019-2028 and a slightly reduced primary surplus averaging 1.1% of GDP, general government debt declines steadily to 40.0% in 2028. Serbia's debt structure is more exposed to foreign-currency risk than peers; the FX-denominated share in total debt fell to 73.8% last year from 77.0% at end-2017, but remains above the current 'BB' median of 60.0%.

Fitch expects the current account deficit to widen by 0.3pp in 2019 to 5.5% of GDP due to lower export volume growth, consumption recovery and robust investment growth lifting imports, and a higher net primary income deficit. We forecast the deficit to narrow to 5.0% in 2020 as external demand recovers. Net FDI reached 7.5% of GDP in 2018 (having increased by around 1pp in each of the previous two years), and we expect it to reduce to an average 5.2% of GDP in 2019-2020, still covering the current account deficit. Risks are also mitigated by the high capital and export-orientated content of imports. Fitch forecasts a small reduction in international reserves to 4.3 months of current external payments, from 4.5 in 2018 (similar to the current 'BB' median of 4.2) and for net external debt/GDP to increase by 3.9pp in 2018-2020 to 26.4% (above the current peer median of 19.1% of GDP).

Serbia's structural reform has been much slower than the macroeconomic adjustment of recent years. The IMF PCI provides some momentum, with its focus on structural measures particularly in areas of governance. Earlier progress had been made in lowering contingent liabilities from state-owned enterprises, including last year's privatisation of the RTB Bor Copper Mine, and annual budget subsidies to SOEs fell to 1.1% of GDP in 2018 from 2.2% in 2016. Reforms to reduce inefficiencies in the public sector wage system have been postponed to next year, while other areas targeted include improving weak corporate governance in public entities and furthering tax administration efforts. Substantial structural reform progress represents an upside risk to Serbia's medium-term GDP growth potential.

Fitch anticipates broad continuity in policy and governance. There have been widespread political protests against the government since last December centred on issues of rule of law and media freedom, but in our view, opposition parties remain fragmented and President Vucic is well placed to continue in power. On the issue of EU membership, the government continues to work towards the target accession date of 2025 but progress has slowed, with the chapters on rule of law and Kosovo the most problematic. Relations with Kosovo are severely strained, with 100% tariffs on Serbian exports still in place and little sign of a compromise on a potential land swap agreement.

Serbia's banking sector remains well-capitalised (Tier 1 capital ratio of 22.3%) and there was some further reduction in the NPL ratio to 5.7% in 4Q18, from 7.8% six months earlier (and 21.6% in 2015). Lending growth is strong, at 12.2% yoy in December, particularly consumer lending. Progress in

addressing weaknesses in state-owned banks (which account for 16% of total banking sector assets) remains mixed, and includes the planned privatisation of Komercijalna Banka, Serbia's third-largest bank, targeted for later this year.

## SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Serbia a score equivalent to a rating of 'BB+' on the Long-Term FC IDR scale.
Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

- Macroeconomics: -1 notch, to reflect relatively weak medium-term growth potential due to structural rigidities, including adverse demographics, the large and inefficient public sector, relatively high unemployment, a large informal economy, low savings rate, and aspects of the business environment and administrative capacity that hinder productivity.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

## RATING SENSITIVITIES

The following factors may, individually or collectively, result in positive rating action:

- An improvement in medium-term growth prospects without creating macro-economic imbalances, for example due to structural reform progress.
- Further reduction in the government debt-to-GDP ratio.
- Greater confidence that recent improvements in macroeconomic stability, including reduced external vulnerabilities, will be sustained.

The following factors may, individually or collectively, result in negative rating action:

- Rising government debt/GDP, for example due to a significant fiscal loosening and/or weaker GDP growth.
- A recurrence of exchange rate pressures leading to a fall in reserves and a sharp rise in debt levels and interest burden.
- Worsening of external imbalances leading to increased external liabilities.

## KEY ASSUMPTIONS

- Global macroeconomic developments are in line with Fitch's Global Economic Outlook (March 2019).
- Fitch assumes that EU accession talks will remain an important policy anchor.

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR affirmed at 'BB'; Outlook Stable
Long-Term Local-Currency IDR affirmed at 'BB'; Outlook Stable
Short-Term Foreign-Currency IDR affirmed at 'B'
Short-Term Local-Currency IDR affirmed at 'B'
Country Ceiling affirmed at 'BB+'
Issue ratings on long-term senior unsecured debt affirmed at 'BB'