FITCH UPGRADES SERBIA TO 'BB+'; OUTLOOK STABLE

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Fitch Ratings has upgraded Serbia's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'BB+' from 'BB'. The Outlook is Stable.

KEY RATING DRIVERS

The upgrade of Serbia's IDRs reflects the following key rating drivers and their relative weights:

HIGH

There has been a consolidation of the more stable macroeconomic position of recent years, underpinned by the IMF Policy Coordination Instrument (PCI) in place since July last year (and which followed the 2015-2018 IMF Standby Arrangement). Inflation remains low and relatively stable, at 1.3% in August and averaging 2.1% in 2019, and inflation expectations are well anchored, which allowed the National Bank of Serbia (NBS) to cut its main policy rate by 50bp since June to 2.5%. Fitch forecasts a gradual rise in inflation to the NBS central target of 3.0% in 2021. The exchange rate has continued to be broadly stable this year, with NBS increasing net FX purchases since June (to a total EUR2.0 billion in 2019, compared with EUR1.6 billion in 2018) in response to some appreciation pressures on the back of strong capital inflows. Serbia's foreign exchange reserves rose to EUR13.1 billion in August, from EUR11.3 billion at end-2018, enhancing its resilience to external shocks.

The government has maintained fiscal discipline following the large consolidation effort that delivered general government surpluses averaging 0.9% of GDP in 2017-2018, from a deficit of 6.2% in 2014 (which included a 3.5% of GDP reduction in spending on wages and pensions). Fitch forecasts a further outperformance against the government deficit target of 0.5% of GDP in 2019-2021. In 1H19 the fiscal surplus reached 0.7% of GDP supported by buoyant tax revenue growth, and we forecast a full-year surplus of 0.1% due to back-ended spending on roads projects together with an additional public sector wage increase and pension payment. Fitch anticipates a broadly flat fiscal balance in 2020 and 2021, with deficits of 0.1% and 0.2% respectively, as higher capital and social expenditures (in part related to next April's parliamentary election) are offset by robust revenue growth and debt interest savings. These deficits still compare favourably with the current 'BB' median of 2.9% of GDP.

Fitch has greater confidence that general government debt is on a firmly downward path, which we forecast at 46.2% of GDP in 2021, down from 54.5% in 2018 (and a peak of 71.2% in 2015), close to the current 'BB' median of 44.6%. Risks to fiscal policy beyond the January 2021 expiration of the IMF PCI are partly mitigated by the strong political priority that the government attaches to meeting its fiscal targets, and by our expectation that fiscal rules will be developed during the remainder of the PCI. Under our longer-term debt projections, which assume average GDP growth of 3.0% from 2019-2028 and a 1.1% of GDP deterioration in the primary surplus between 2021-2026, general government debt declines steadily to 37.4% of GDP in 2028.

There has been a moderate improvement in Serbia's public debt structure. Around 75% of new debt issued in 2019 is dinar-denominated (from 65% last year) and there has been further repayment of more expensive US dollar-denominated bonds (totalling USD1.75 billion). The overall FX-share of outstanding public debt fell to 72.5% in July, from 77.0% at end-2017, although it is still well above the current 'BB' median of 55.2%. The average maturity of central government debt has also lengthened to 6.2 years from 5.1 at end-2016, locking in more favourable financing conditions; June's 10-year EUR1 billion Eurobond issuance had a record low yield of 1.62%, and the average cost of central government debt is projected to fall to 3.6% at end-2019, from 4.5% at end-2016.

MEDIUM

There has been a further improvement in the credit fundamentals of the banking sector, particularly on asset quality, which has helped support stronger lending growth, of 10.1% in July. The NPL ratio fell to 5.0% at end-July, from 5.7% at end-2018 (and 21.6% in 2015), while the coverage ratio has been broadly stable with IFRS provisions at 61.3%. The sector is well capitalised, with a Common Equity Tier 1 ratio of 22.1% at end-June, up from 21.1% six months earlier and profitability has been robust, with a return on equity of 10.0% in 1H19. Progress in addressing weaknesses in state-owned banks (which account for 16% of total banking sector assets) remains mixed, although the sale of the government's 82% share of Komercijalna Banka, Serbia's third-largest bank, is advancing in line with the year-end target.

Serbia's 'BB+' IDRs also reflect the following key rating drivers:

Serbia's governance, ease of doing business, and human development indicators compare favourably with the peer group medians. Public debt reduction is supported by a large and stable tax base, and the IMF PCI provides a near-term policy anchor for further strengthening of macroeconomic fundamentals. 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 in 2018, is also wider than the 'BB' median of 3.0% (partly reflecting a low savings rate of 13.2% of GDP) although it has been fully covered by strong FDI flows in recent years.

GDP growth slowed to 2.8% in 1H19, from 4.3% in 2018, due to weakening external demand, the impact of 100% tariffs applied by Kosovo, and one-off factors in the chemicals and oil sectors. We expect a pick-up in 2H19, taking full year growth to 3.2%, due to the fading of these transitory factors, positive labour market dynamics (employment and private sector wages rose 2.6% and 10.5% respectively in 1H19), and stronger public sector and construction investment. Fitch forecasts an increase in GDP growth next year to 3.6% partly due to base effects and some recovery in demand from Germany and Italy (which account for 22.6% of Serbia's exports) followed by a modest slowdown to 3.3% in 2021 as economic slack is steadily absorbed. GDP growth averages 2.9% in 2015-2019, compared with the 'BB' historic median of 4.2%, and unfavourable demographics and weak total factor productivity growth contribute to Serbia's lower growth potential than peers.

Exports have held up relatively well in the face of further eurozone weakness (up 8.5% in 1H19), and we have maintained our 2019 current account deficit forecast of a 0.3pp widening to 5.5% of GDP, driven by some moderation in export volumes, a higher net primary income deficit, and strong FDI and consumption lifting imports. Fitch expects a narrowing of the deficit, to 5.0% in 2021, as external demand recovers. Net FDI continues to grow strongly, at EUR1.8 billion in 1H19 (8.0% of GDP annualised, from 7.5% in 2018) and our forecast for a moderation (to an average 5.7% of GDP in 2019-2021) would still cover the current account deficit. Risks are also mitigated by the high capital and export-orientated content of imports. Fitch projects international reserves at 4.6 months of current external payments in 2021, from 4.5 in 2018 and similar to the current 'BB' median of 4.3, and for net external debt at 24.1% of GDP in 2021 to remain above the peer group median of 17.3%.

Fitch expects broad continuity in policy and governance. Opinion polls indicate that President Vucic is a strong favourite to remain in power after April's elections. The widespread protests against the government earlier this year relating to issues of rule of law and media freedom have abated, although the elections represent another potential flashpoint. Progress towards the 2025 target EU accession has slowed, with the chapters on rule of law and Kosovo the most problematic. Relations with Kosovo remain severely strained, with no dialogue currently and little sign of a compromise on a potential land swap agreement. More generally, Serbia's structural reform progress has been much slower than its macroeconomic adjustment. Recent progress has been made in tax administration and public investment management but the introduction of a new public sector wage system has been delayed and SOE corporate governance remains weak. Despite the added momentum from the

PCI we do not anticipate a marked quickening of reforms, a key factor limiting Serbia's potential GDP growth.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Serbia a score equivalent to a rating of 'BBB-' 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 a) structural rigidities and relatively weak medium-term growth potential, including from 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, and b) our expectation that structural reform progress will remain slow, particularly beyond the expiration of the IMF PCI.

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 for example from structural reforms, increasing the pace of convergence in GDP per capita with higher rated peers.
- Sharper reduction in the government debt-to-GDP ratio.
- Marked reduction in net external debt/GDP.

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.
- Worsening of external imbalances leading to increased external liabilities.

- A recurrence of exchange rate pressures leading to a fall in reserves and a sharp rise in debt levels and interest burden.
- A deterioration in the political environment and governance, negatively impacting the economic outlook.

KEY ASSUMPTIONS

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

ESG CONSIDERATIONS

Serbia has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as strong social stability and voice and accountability are reflected in the World Bank Governance Indicators that have the highest weight in the SRM. They are relevant to the rating and a rating driver.

Serbia has an ESG Relevance Score of 4 for Demographic Trends as adverse demographics constrain medium-term growth prospects, which is a key rating driver for Serbia.

Serbia has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight.

Serbia has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight.

Serbia has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Serbia, as for all sovereigns.

Additional information is available on www.fitchratings.com