RATING ACTION COMMENTARY

Fitch Affirms Serbia at 'BB+'; Outlook Stable

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Fitch Ratings - London - 27 Mar 2020: Fitch Ratings has affirmed Serbia's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB+' with a Stable Outlook

KEY RATING DRIVERS

The resilience of Serbia's rating to the coronavirus shock is supported by its minimal exposure to tourism, the positive impact of lower energy prices, increased foreign exchange reserves and moderate non-resident holdings of government debt. The near-balanced budget coming into 2020 and central government deposits provide some fiscal space to respond, and the fiscal discipline in recent years enhances confidence in a post-crisis adjustment. Nevertheless, Serbia's small, open economy is exposed to the eurozone, and foreign currency external debt is relatively high.

Serbia's governance, ease of doing business, and human development indicators compare favourably with the 'BB' medians. The IMF Policy Coordination Instrument (PCI) in place since July 2018 provides a policy anchor and has underpinned a stable macroeconomic position in recent years, including low inflation, higher FX buffers, and enhanced fiscal policy credibility. Set against these factors are Serbia's higher public debt, greater share of foreign-currency denominated debt, higher net external debt, and somewhat lower GDP growth potential relative to the peer medians. The current account deficit, averaging 5.7% of GDP in 2017-2019, is also wider than the 'BB' median of 2.9% although it has been fully covered by strong FDI flows.

Fitch forecasts GDP growth will slow to 0.2% in 2020, from 4.2% in 2019, a 3.4pp downward revision since our last review six months ago due to the impact of the coronavirus outbreak, and with a sizeable further downside risk. 4Q19 growth outperformed expectations, at 6.2% yoy on the back of surging investment, and activity remained strong early this year, with base effects and a large pipeline of public infrastructure projects providing momentum ahead of a sharp contraction forecast in 2Q20. We assume more far-reaching restrictions on movements during the three-month "state of emergency" than those already announced (a ban on movement of the elderly, evening curfew, and restrictions on social gatherings). The initial policy response includes fiscal measures totalling 0.9% of GDP and a 90-day moratorium on loan repayments.

The National Bank of Serbia cut the policy interest rates by 50bp to 1.75% (and narrowed the interest rate corridor to 1.0pp from 1.25pp) and we forecast a further 75bp of cuts this year. Inflation remained low and stable at 1.9% in February, with core inflation 1.5% (and averaging 1.4% since 2015). We forecast GDP growth of 5.8% in 2021 (2.2pp higher than our previous forecast), supported by investment catch-up, a partial rebound in private consumption, resumption of employment growth and a recovery in external demand, partly offset by fiscal tightening. Over a longer period, Serbia's average GDP growth has been below the 'BB' median (3.1% versus 4.2% in 2015-2019) and unfavourable demographics and weak total factor productivity growth weigh on Serbia's growth potential.

An expected current account adjustment in 2020 helps mitigate near-term balance of payments risks from highly stressed market conditions. The deficit widened to 6.9% of GDP in 2019 as 18% investment growth pushed up imports. Fitch forecasts the current account deficit will narrow to 4.0% this year due to lower imports from the sharp fall in domestic demand, moderating FDI inflows and the lower oil price, with only a partial offset from weaker exports, and then increases to 5.6% in 2021. A USD10 dollar decline in the oil price improves the current account balance by an estimated 0.4% of GDP, there are negligible net tourism exports (0.05% of GDP in 2019), and there is a high capital and export-oriented content of imports. We expect a similar pattern in net FDI inflows, falling to 4.6% of GDP this year, from 7.8% in 2019, and then rebounding to 7.4% in 2021, more than covering the current account deficit in each year.

Serbia's foreign exchange reserves increased to EUR13.5 billion in February, from EUR11.4 billion a year earlier, equivalent to 5.1 months of current external payments months, above the peer group median of 4.5 months. Available data indicates only moderate capital outflows so far this year and the exchange rate has been stable between EUR/RSD117.5 and 118. There was a small net sale of FX by National bank of Serbia in the first two months of 2020 totalling EUR50 million, and we do not expect a sizeable intervention this month. Fitch forecasts FX reserves fall to 4.5 months of current external payments at end-2020, increasing to 5.0 months at end-2021, and net external debt/GDP is broadly flat at 32% of GDP, which compares unfavourably with the current 'BB' median of 19%.

The near balanced general government position, of -0.2% of GDP in 2019 (following a surplus of 0.6% in 2018, and below the current 'BB' median deficit of 2.8%) provides some fiscal space to respond to the coronavirus shock. Fitch forecasts the general government deficit will widen to 3.2% of GDP this year, 3.1pp higher than our previous forecast, and that the fiscal response is largely consistent with IMF PCI waivers to the current target for a 0.5% of GDP deficit. In addition to new spending on health, pensions, and infrastructure announced this month, there are proposals to reduce payroll tax and advance payment of corporate tax, on top of which we anticipate more far-reaching support measures to the most affected areas. The increase in the deficit is mitigated by likely under-execution on capital projects and some reprioritisation of non-essential spending.

Fitch forecasts a general government deficit of 0.3% of GDP in 2021 as GDP growth rebounds and temporary measures are unwound, underpinned by the government's strong political commitment to its medium-term fiscal deficit target of 0.5% of GDP. General government debt has fallen steadily to 52.9% of GDP at end-2019 from 54.4% in 2018 (and 71.2% in 2015) but remains above the current 'BB' median of 46.5%. We project an increase to 55.0% this year, falling back to 50.8% at end-2021.

Only around 10% of this month's Eurobond redemption was rolled over due to weak demand and there is now a greater focus on domestic issuance targeting local banks. An increase in fiscal reserves to 8.3% of GDP at end-2019 mitigates funding risks The average maturity of central government debt has lengthening to 6.3 years from 5.1 years at end-2016 but the FX-share of public debt at 72.3% remains well above the current 'BB' median of 56.0%. Under our longer-term debt projections, which assume average GDP growth of 3.4% from 2020-2029 and a 1% of GDP deterioration in the primary surplus between 2021-2026, general government debt declines to 38% of GDP in 2029.

Fitch anticipates broad continuity in policy and governance, with polls indicating that President Vucic's ruling coalition is strong favourite to win elections that have been postponed from April due to the coronavirus outbreak. Prior to the outbreak, the opposition had threatened to boycott the

elections citing concerns over media freedom and electoral processes, and there is a possibility the elections revive the widespread protests against the government seen earlier last year but we would not expect a significant macroeconomic impact from this.

There has been only gradual progress in the EU accession process, and a long delay to the 2025 target date is expected, with the chapters on rule of law and Kosovo the most problematic. Relations with Kosovo continue to be severely strained, with no dialogue, little sign of compromise on a potential land swap agreement, and tariffs applied by Kosovo to exports largely remaining in place.

Structural reform implementation has been relatively slow in recent years, and will be further pushed back by the coronavirus state of emergency. There has been steady progress in strengthening tax administration and public financial management, but the introduction of a new public wage system has again been delayed. The next PCI review in May is expected to incorporate measures to develop the domestic capital market, and extend fiscal rules, which may help provide a fiscal anchor beyond next year's expiration of the PCI. More broadly, Fitch does not anticipate a marked quickening of structural reforms that would support an increase in Serbia's potential GDP growth.

There has been a steady improvement in the credit fundamentals of the banking sector, increasing the resilience to current market stresses. The NPL ratio has continued to fall, to 4.1% at end-2019 from 5.7% at end-2018 (and 9.8% at end-2017) and the coverage ratio has been broadly flat at 60.7% at end-2019. The sector is well capitalised, with the CET1 ratio increasing to 23.6% at end-2019 from 22.3% a year earlier, providing a buffer to absorb the likely weakening in asset quality in 2020. A lower net interest margin contributed to the return on equity falling 1.5pp in 2019 to 9.8% and we expect a further reduction in profitability this year partly due to credit growth slowing, from 10% currently. 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 83% stake in Komercijalna Banka, Serbia's third-largest bank, has been agreed, at around EUR400 million (0.8% of GDP).

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, one-notch lower than the 'BBB-' SRM score at our previous review (where it was at the boundary of BB+).

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final Long-Term Foreign-Currency IDR. The removal of the -1 notch under Macroeconomics since the previous review reflects stronger than expected (and more broad-based) investment dynamics and outturns in 2019, contributing to a view that Serbia's longer-term trend GDP growth is closer to the peer group medium.

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:

-General government debt/GDP returning to a firm downward path over the medium-term, for example due to a post-coronavirus-shock fiscal consolidation.

-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.

-Marked reduction in net external debt/GDP.

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

-A recurrence of external financing pressures leading to a fall in reserves and a sharp rise in debt levels and interest burden, a high share of which is denominated in foreign currency.

-A sustained increase in general government debt/GDP over the medium-term, for example due to a structural fiscal loosening and/or weaker GDP growth prospects.

-Worsening of external imbalances leading to increased external liabilities.

KEY ASSUMPTIONS

Fitch assumes that EU accession talks will remain an important policy anchor.

ESG CONSIDERATIONS

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 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 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.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Serbia	LT IDR	BB+	Affirmed	BB+
•	ST IDR	B	Affirmed	B
•	LC LT IDR	BB+	Affirmed	BB+
•	LC ST IDR	B	Affirmed	B
•	Country Ceiling	BBB-	Affirmed	BBB-
• senior unsecured	LT	BB+	Affirmed	BB+

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

- Sovereign Rating Criteria (pub. 27 May 2019)
- Country Ceilings Criteria (pub. 05 Jul 2019)

ADDITIONAL DISCLOSURES

- Dodd-Frank Rating Information Disclosure Form
- Solicitation Status
- Endorsement Policy

ENDORSEMENT STATUS

Serbia EU Issued

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