Fitch Affirms Serbia at 'BB+'; Outlook Stable

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Fitch Ratings - London - 25 Sep 2020: Fitch Ratings has affirmed Serbia's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB+' with a Stable Outlook.

KEY RATING DRIVERS

Serbia's ratings are supported by its relatively good economic performance compared with rating peers, and a policy response that we expect to help generate a firm recovery from the pandemic shock. Macroeconomic policy credibility built up over recent years, anchored by the IMF Policy Coordination Instrument (PCI), has resulted in low inflation, and higher FX buffers, and enhances confidence in a post-crisis fiscal adjustment. Resilience to the coronavirus shock is also supported by Serbia's minimal exposure to tourism and the positive impact of lower energy prices. Governance, human development indicators, and GDP per capita compare favourably with the 'BB' medians. Set against these factors are Serbia's higher public debt, greater share of foreign-currency denominated debt, and higher net external debt. The current account deficit is also wider than the 'BB' median although it has been fully covered by strong FDI flows in recent years.

Fitch forecasts GDP will contract by 2.2% in 2020, following growth of 4.2% last year and less than the projected 'BB' median contraction of 4.8%. The economy grew 5.1% yoy in 1Q20 and a large fiscal stimulus, a relatively short lockdown, and resilient FDI helped limit the contraction in 2Q20 to 6.4%. Support measures have kept employment broadly stable, and the fall in the unemployment rate to 7.3% in 2Q20 from 9.7% in 1Q20 was driven by a 2.3pp increase in the inactivity rate. The National Bank of Serbia (NBS) has cut the main policy rate by 100bp since March and we forecast a further 25bp cut to 1% by year-end, then unchanged through 2021. Inflation, which has remained low and stable, averaging 1.5% in the year to August, is projected to gradually increase to an average 2.3% in 2021-2022.

A second wave of coronavirus infections in July had a much less pronounced impact on economic activity than in April, and the infection rate has since fallen back from around 400 new cases per day to below 100, although a further spike represents a key risk to the outlook. GDP is projected to grow 5.2% in 2021, driven by recovering external demand, investment catch-up, and a partial rebound in private consumption, partly offset by the unwinding of fiscal measures. We forecast growth will remain above trend in 2022, at 4.8%, partly due to a still sizeable negative output gap. Serbia's GDP growth averaged 3.1% in 2015-2019, and unfavourable demographics and weak total factor productivity growth weigh on longer-term growth potential.

The government's fiscal response to the shock totals close to 8% of GDP this year (taking into account revenue and spending measures but excluding guarantees of bank loans), and Fitch forecasts the general government deficit increases to 8.1% of GDP in 2020, from 0.2% in 2019. The large majority comprises deferred employment tax, wage subsidies, additional healthcare spending, and a universal cash transfer, all of which expire in 2020 (with the exception of healthcare pay rises totalling 0.4% of GDP). We assume only very targeted extension of fiscal measures, and forecast the general government deficit narrows to 2.8% of GDP in 2021 and 1.7% in 2022, below the projected 'BB' medians of 4.7% and 3.6%. The government's fiscal targets, for a deficit of 2.0% of GDP in 2020 and then a steady return to a medium-term deficit of 0.5%, are expected to remain key anchors of its macroeconomic strategy.

There has been a moderate increase in contingent liability risk, including from state guarantees of bank loans extended this year, which are not expected to be called before 2022 and are capped at EUR480 million (1% of GDP). There is also discussion of support to Air Serbia ahead of a loan falling due over the next month totalling 0.3% of GDP, and we consider other contingent liability risks from state-owned enterprises have increased somewhat.

The government has executed almost 95% of its planned debt issuance for 2020, including a EUR2 billion (4.4% of GDP) seven-year Eurobond in May, at a yield of 3.4%. Domestic issuance, totalling RSD277 billion (5.2% of GDP) in the year to mid-September, was helped by the additional capacity created by EUR825 million of outright purchases by NBS of government securities from banks. IMF Rapid Financing Instrument funds of close to EUR850 million are also available to Serbia, further mitigating funding risks. The average maturity of central government debt has lengthened to 6.5 years from 5.1 years at end-2016 but the foreign-currency share of public debt at 71% remains well above the current 'BB' median of 59%.

Fitch forecasts general government debt, which had fallen to 52.9% of GDP at end-2019 from 68.8% at end-2016, increases to 59.0% of GDP at end-2020. We then project a fall to 54.9% of GDP by end-2022. These incorporate a debt reducing adjustment for the sale of the government's 83% stake in Komercijalna Banka of 0.8% of GDP, which is expected at the end of this year, offset by crystallisation of SOE contingent liabilities totalling 1.0% of GDP in 2021-2022. The potential for further government support represents a risk to our forecasts. Under our longer-term debt projections, which assume average GDP growth of 3.9% and a 0.4pp improvement in the primary surplus in 2023-2024, general government debt declines to 51.0% of GDP at end-2024.

Serbia's balance of payments position has been resilient to the coronavirus shock. We forecast the current account deficit narrows to 5.8% of GDP, from 6.9% of GDP in 2019 helped by lower oil prices and by the high capital and export-oriented content of imports. Serbia also has a near-balanced net tourism position. Net FDI moderated in 7M20 to EUR1.6 billion (from EUR3.6 billion for 2019 as a whole) but still covered 107% of the current account deficit, and

we project a pick-up to average 6.1% of GDP in 2021-2022. We forecast the current account deficit will steadily narrow, to 5.5% of GDP in 2022 (but still well above the projected 'BB' median of 2.1%) partly due to the sharper recovery in the eurozone (which accounts for 40% of Serbia's exports).

Foreign exchange reserves have been broadly stable at EUR13.4 billion in August, from EUR13.1 billion in March and a peak of EUR14.3 billion in May. There have been limited capital outflows and the exchange rate has remained between EUR/RSD117.5 and RSD118.0, with net FX sales by NBS totalling EUR1.5 billion this year. Fitch forecasts FX reserves increase to 5.5 months of current external payments at end-2022 from 5.1 months at end-2019, above the projected 'BB' median of 4.4 months. Net external debt/GDP is projected to widen 4.1pp in 2020 to 36.8% and then narrow to 33.3% in 2022, still above the peer group median of 24.5%.

Fitch anticipates that economic policy and the relatively slow pace of structural reform will remain largely unchanged, following the strengthened position of President Vucic's SNS party from June's election. The composition of the new government is set to be announced over the next month and we expect there will be a renewal of the previous coalition agreement with SPS. The main opposition parties boycotted the election, citing concerns over media freedom and electoral processes and have announced they will not participate in the presidential elections due by April 2022 but anti-government protests have not resulted in widespread disorder.

The coronavirus shock and absence of a full government since May has set back the already limited reform momentum, and there have been delays to the introduction of a new public sector wage system and fiscal rules. Measures have been advanced in strengthening tax administration and public financial management, and the remainder of the IMF PCI, which expires in January, is expected to include a focus on improving risk management and weak governance in state-owned enterprises. Fitch considers it likely there will be renewed Fund engagement following the expiration of the PCI, the nature of which is currently unclear, helping to anchor macro and fiscal policy.

EU accession progress has remained slow, with no new chapters opened over the last year. The most problematic areas continue to relate to the rule of law, and Fitch expects a long delay to the 2025 target date. Relations with Kosovo have improved over the last six months, and the 100% tariffs applied on Serbian exports were lifted in April. A recent US-brokered agreement is a further step to normalising relationships with Kosovo and includes plans to undertake joint infrastructure projects although there is considerable implementation risk.

Banks' sound credit metrics have helped the sector absorb the coronavirus shock. The sector is well capitalised, with a CET1 ratio of 21.8% at end-June, and 76% of the sector (by assets) is foreign-owned which also reduces contingent liability risk. The NPL ratio fell further to 3.6% in July, from 4.1% at end-2019 (and 17.0% at end-2016), although a weakening in asset quality from next year is likely, as support measures fall away. A lower net interest margin

contributed to the return on equity falling 2pp since end-2018 to 8.3% in June and we expect a further reduction in profitability this year. The share of local currency deposits in total deposits increased to 38.5% in June from 35.6% in March but well below the 'BB' median of 75.5%. NBS liquidity measures have helped lift the liquidity ratio to 210% from 200% at end-2019, and the state loan guarantees also supported strong credit growth, of 13.6% yoy in July.

ESG - Governance: Serbia has an ESG Relevance Score of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Serbia has a medium WBGI ranking, at the 50th percentile, reflecting a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a moderate level of corruption.

RATING SENSITIVITIES

The main factors that could, individually or collectively, lead to positive rating action/upgrade are:

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

Macro: Greater convergence in GDP per capita with higher rated peers, for example due to structural reforms improving medium-term growth prospects.

External Finances: Reduction in external vulnerabilities, for example from a smaller share of foreign currency external government debt, and a fall in overall net external debt/GDP.

The main factors that could, individually or collectively, lead to negative rating action/downgrade:

External and Public Finances: Acute 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 foreign-currency denominated.

Public Finances: 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.

External Finances: Worsening of external imbalances leading to increased external liabilities.

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 did not adjust the output from the SRM to arrive at the final Long-Term Foreign-Currency IDR.

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.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

KEY ASSUMPTIONS

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

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.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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+

Additional information is available on www.fitchratings.com.

Source: Fitch Ratings.