RATING ACTION COMMENTARY

Fitch Affirms Serbia at 'BB+'; Outlook Stable

Fri 19 Mar, 2021 - 5:02 PM ET

Fitch Ratings - London - 19 Mar 2021: Fitch Ratings has affirmed Serbia's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) at 'BB+' with a Stable Outlook

KEY RATING DRIVERS

Serbia's ratings are supported by macroeconomic policy credibility, which has resulted in low inflation, higher foreign-exchange (FX) buffers, relative macroeconomic resilience to the coronavirus shock, and underpins our confidence in a post-crisis fiscal adjustment. Governance, human development indicators, and GDP per capita compare favourably with 'BB' medians. Set against these factors are Serbia's greater share of foreign-currency denominated public debt, somewhat higher net external debt/GDP, and wider current account deficit (although fully covered by strong foreign direct investments (FDI) in recent years) than peer group medians. Its banking sector has a high degree of euroisation and Serbia's small open economy is exposed to the eurozone.

GDP contracted 1% in 2020, less than the 'BB' median contraction of 4.8%, helped by a large fiscal support package (6.3% of GDP), strong wage growth, and resilient FDI. Fitch forecasts the economy to grow 5.2% in 2021, supported by a positive carry-over effect, and strengthening activity in 2H21 due to Serbia's fast vaccination rollout (currently 22 doses per hundred people) and recovering demand from the eurozone (which comprises 40% of exports). We project growth to remain above trend in 2022, at 4.5%. Serbia's GDP growth averaged 3.2% in 2015-2019, and unfavourable demographics and weak total factor productivity growth weigh on longer-term growth potential. Inflation has remained low and stable at 1.2% in February, averaging 2% over the last seven years.

A credible fiscal anchor supports our expectations for steady fiscal consolidation. The general government deficit widened 7.9pp in 2020 to 8.1% of GDP, and our forecast for a narrowing to 4.9% in 2021 incorporates recently announced temporary support measures totalling 2% of GDP. Fitch projects the deficit to fall to 2% of GDP in 2022, below the projected peer group median of 4.3%. The IMF Policy Coordination Instrument (PCI) expired in January and we anticipate a follow-on PCI will be approved in 2H21 and that new fiscal rules agreed under it will target a medium-term deficit of near 1% of GDP. Last year's financing needs were comfortably met, including EUR3 billion (6.2% of GDP) of Eurobond issuance in May and November, and a further EUR1 billion in February, and the single treasury account reserve rose to 4.7% of GDP in March, from 3% at end-2019.

General government debt increased 5.3pp in 2020 to 58.2% of GDP, which compares with the 'BB' median of 59.9%. 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 69.5% remains well above the peer group median of 46.9%. Fitch forecasts general government debt/GDP to peak at 59.6% at end-2021 and to fall to 58.5% at end-2022. Contingent liability risks have moderately increased, including from the bank loan guarantee scheme (capped at 1.4% of GDP) and from Air Serbia, but from a relatively low base.

Serbia's external finances have been resilient to the coronavirus shock and FX reserves increased to EUR13.6 billion at end-January 2021 from EUR13.1 billion in March 2020. A 2.6pp improvement in the 2020 current account deficit to 4.3% of GDP more than offset a 1.5pp moderation in net FDI to 6.2% of GDP. Net FX sales have been limited since end-2019 at EUR1.5 billion, and the euro/dinar exchange rate at 117.4 is at the pre-pandemic level. Net external debt/GDP fell 3pp in 2020 to 29.3% of GDP but remains higher than the peer group median of 21.5%. Fitch forecasts the current account deficit to widen to 6% of GDP in 2021-2022 as strengthening domestic demand lifts imports, and repatriation of foreign company profits increases. We project broadly flat FX reserves at 5.7 months of current external payments at end-2022, above the 'BB' median of 4.9 months.

The pandemic set back already limited structural reform momentum, and the presidential and parliamentary elections due by April 2022 will act as a further constraint. It is uncertain whether the opposition will continue to boycott the elections due to concerns over electoral processes and media independence. While there could be a repeat of last year's widespread anti-government protests, we consider it unlikely this would threaten the stability of the administration or economic confidence. President Vucic and his SNS party are strong favourites for re-election, and we anticipate broad continuity in economic policy. A new IMF PCI is expected to focus on more structural measures from the previous programme that were not advanced, including improving weak governance in state-owned enterprises and fiscal risk management.

Fitch anticipates that progress towards EU accession will remain slow, with a long delay to the 2025 EU accession target date. No new chapters have been opened since 2019, and rule of law and relations with Kosovo continue to be the most problematic areas. Entrenched vested interests are likely to constrain implementation of measures on the judiciary, anti-corruption, organised crime, and freedom of expression. Last year's US-brokered agreement was a step towards normalising relationships with Kosovo, but we do not expect substantive progress towards a sustainable settlement ahead of the Serbian general elections next year.

The Serbian banking sector has sound credit metrics, including a CET1 ratio of 21.4%, and 86% of the sector (by assets) is foreign-owned, reducing contingent liability risk.

The non-performing loan (NPL) ratio fell to 3.7% at end-2020 from 4.1% at end-2019 (and 17% at end-2016) and we expect a moderate increase this year as support measures and regulatory forbearance expire. The banking sector has remained liquid, and credit growth is fairly strong, at 9.4% yoy in January. The share of deposits in foreign currency has steadily fallen to 59.9% at end-2020 from 64.9% at end-2019 but compares unfavourably with the 'BB' median of 20.5%, and the share of loans in foreign currency is also fairly high at 62.7%.

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 (SRM). Serbia has a medium WBGI ranking, at the 49th 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: 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'.

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

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

External Finances: An increase in external vulnerabilities, for example from acute financing pressures or a worsening of imbalances, leading to a fall in FX reserves, higher external debt and interest burden.

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, or currency depreciation resulting in a sharp rise in general government debt and interest burden.

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

Fitch's proprietary SRM assigns Serbia a score equivalent to a rating of 'BB+' on the LTFC IDR scale.

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LTFC 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 LTFC 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 WBGI 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 WBGI 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 the Voice and Accountability pillar of the WBGI 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(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.