RATING ACTION COMMENTARY

Fitch Affirms Serbia at 'BB+'; Outlook Stable

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Fitch Ratings - London - 03 Sep 2021: Fitch Ratings has affirmed Serbia's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BB+' with a Stable Outlook

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

KEY RATING DRIVERS

Serbia's rating is supported by a credible macroeconomic policy framework, relatively low inflation, somewhat higher foreign exchange reserves, and stronger governance, human development and GDP per capita compared with 'BB' medians. Economic resilience to the pandemic shock, a limited increase in public debt, and our confidence in fiscal consolidation prospects also support the rating and Stable Outlook. Set against these factors are Serbia's greater share of foreign-currency denominated public debt, higher net external debt, and persistently wider current account deficit than peer group medians, as well as a high degree of banking sector euroisation.

Fitch has revised up its GDP growth forecast for 2021 to 6.3% on the back of a strong rebound in domestic demand in 1H21, above the 'BB' median of 4.7%. There has been a fast Covid-19 vaccination rollout, at 86 doses per 100 people, but recent progress has stalled due to vaccination scepticism, and the potential for economic restrictions to contain a new wave represents a risk to our forecast. We project GDP growth moderates to 4.4% in 2022 and 3.9% in 2023, slightly above our assessment of the trend rate, which is constrained by unfavourable demographics and weak total factor productivity growth.

Inflation rose to 3.3% in July, from 1.1% in January, mainly due to supply-side pressures with core inflation more stable at 2.0%, and we project a moderation to an average 2.6% in 2022-2023, within the target band. Inflation has averaged 2.0% over the last seven years, below the 'BB' median of 2.9%.

We anticipate a steady reduction in the general government deficit in 2021-2023, following last year's large stimulus package, which drove a 7.9pp widening to 8.1% of GDP. The deficit narrowed sharply in 1H21 to 1.3% of GDP (annualised), with tax revenues up 21% yoy, and large expenditure under-execution. Fitch forecasts a full-year deficit of 5.5% of GDP, which assumes new discretionary fiscal spending partly related to next year's elections and a marked acceleration of capital execution, but still below the government's target of 6.9%. We project the general government deficit narrows to 3.2% in 2022 as support measures are unwound and to 1.9% in 2023, and expect fiscal rules will be developed under the new IMF Policy Coordination Instrument (PCI), targeting a medium-term deficit of below 1% of GDP.

Financing conditions have improved, with the inclusion of three benchmark bonds in the JP Morgan Emerging Market Index helping revive demand for domestic debt, which could be further supported by potential access to Euroclear settlement in 2022. There has been continued strong demand for Serbian Eurobonds, which we expect will comprise near 60% of full-year financing, and the single treasury account reserve had risen to 4.5% of GDP at end-August, from 3.2% a year earlier.

Fitch forecasts general government debt/GDP to peak at 59.5% in 2021 (having increased 5.4pp last year to 58.2%) and gradually decline to 57.7% at end-2023, broadly in line with the projected 'BB' median of

57.0%. The average maturity of government debt has lengthened to 6.7 years from 6.1 at end-2019 and the foreign-currency share of debt reduced 2pp to 69%, but is well above the peer group median of 51%.

Foreign exchange reserves rose to EUR14.6 billion at end-July, from EUR13.5 billion at end-2020, and above the pre-pandemic level. Net external debt is projected to fall 6.6pp in 2021 to 28.6% of GDP, but still compares unfavourably with the peer group median of 18.4%. The current account deficit narrowed 2.6pp in 2020 to 4.3% of GDP and to 1.7% of GDP (annualised) in 1H21, and Fitch forecasts a widening to average 3.7% of GDP in 2022-2023 due to higher repatriation of foreign company earnings and stronger import growth. However, we project this continues to be more than covered by average net FDI inflows of 5.9% of GDP in 2021-2023, and foreign exchange reserves rise from 6.1 months of current external payments at end-2021, to 6.6 at end-2023, above the 'BB' median of 5.2 months.

Fitch expects broad policy continuity, with consolidation of the macroeconomic framework helped by the renewal of the IMF PCI, but much more limited progress on structural reforms. As anticipated, a new 30-month PCI was agreed in June, which includes measures to enhance public financial management, strengthen SOE governance, and develop capital markets. President Vucic and his SNS party are overwhelming favourites to win presidential and parliamentary elections scheduled by April 2022.

The opposition is highly fragmented and the outcome of their negotiations with the government over electoral processes and media representation is uncertain, but our base case is for opposition participation in the elections. While there could be a repeat of widespread protests around the election, we do not expect this would threaten the stability of the administration or economic confidence.

Progress towards EU accession has remained slow, with no new areas opened since 2019. The revised EU process of bringing together technical competencies into clusters has been operationalised this year, with one cluster agreed. Fitch expects a long delay to the target EU accession date of 2025, with rule of law and relations with Kosovo the main constraints. Entrenched vested interests are likely to hold back measures on freedom of expression, judicial reform, anti-corruption, and organised crime, and EU standards in these areas could be higher than for previous accession countries. Last September's US brokered agreement was a step towards normalising economic relations with Kosovo, but there has since been a lack of tangible progress towards a sustainable settlement which is unlikely to change ahead of next year's general election.

The Serbian banking sector's sound credit metrics have weathered the pandemic well. The sector has remained liquid, credit growth has been robust at 8.5% yoy in July, the common equity Tier 1 ratio broadly flat at 21.4%, and 84% of the sector (by assets) is foreign-owned, reducing contingent liability risk. The non-performing loan (NPL) ratio continued a downward trend to 3.6% in June, from 4.1% at end-2019 (and 17% at end-2016). The coverage ratio has remained high at 58%, and we expect only a modest increase in the NPL ratio in 2H21 as pandemic support measures are unwound. The share of deposits in foreign currency fell to 60% in June, from 63% at end-2019, but compares unfavourably with the 'BB' median of 18%.

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

Factors that could, individually or collectively, lead to negative rating action/downgrade:

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 a sharp rise in the interest burden and government indebtedness due to currency depreciation.

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.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

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.

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

- The global economy performs broadly in line with Fitch's latest Global Economic Outlook published on 15 June 2021

- 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. As Serbia has a percentile below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

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. As Serbia has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

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. As Serbia has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

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. As Serbia has a fairly recent restructuring of public debt in 2004, this has a negative impact on the credit profile.

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.