Fitch Affirms Serbia at 'BB+'; Outlook Stable

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Fitch Ratings - London - 25 Feb 2022: 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

Policy Credibility Supports Stable Outlook: Serbia's rating is supported by its credible macroeconomic policy framework and prudent fiscal policy, and somewhat stronger governance, human development and GDP per capita compared with 'BB' medians. Set against these factors are Serbia's greater share of foreign-currency (FC) denominated public debt and higher net external debt than peer group medians, as well as a high degree of banking sector euroisation.

Planned Fiscal Consolidation: The general government deficit narrowed 3.8pp in 2021 to 4.2% of GDP ('BB' median 5.2%) driven by a rebound in tax revenue, and unwinding of pandemic support. Fitch projects the deficit will fall to 3.1% in 2022, as robust tax revenue growth and phasing out of remaining pandemic measures more than offset moderate election-related transfers and energy subsidies. We forecast a further narrowing to 1.8% of GDP in 2023, anchored by new fiscal rules, which we anticipate will be agreed with the IMF in 2H22.

Public Debt Stabilises: Fitch forecasts general government debt/GDP, which stabilised in 2021 at 57.5%, will steadily fall to 52.5% at end-2023, below the projected 'BB' median of 56.0%. We assume that the majority of new debt issued this year is domestic, reflecting more challenging external financing conditions, and that the IMF SDR allocation (1.3% of GDP) is fully used in 1H22. Access to Euroclear settlement will provide a modest boost to demand for public debt from 1Q23. The average maturity of central government debt has lengthened to 8.3 years from 6.1 years at end-2019, but the FC share has edged up to 71.5%, well above the peer group median of 50.4%.

Moderate Trend Growth, Inflationary Pressure: Economic growth rebounded strongly in 2021 by 7.5%, driven by domestic demand, and Fitch forecasts it slows to 4.3% in 2022 due to base effects and cooling real wage growth. Growth is projected to moderate to 3.8% in 2023 (in line with the projected 'BB' median), slightly above our assessment of Serbia's trend rate. Growth potential is constrained by Serbia's weak demographics, low productivity growth, and skills mismatches, which we expect will exert more of a drag from next year. Inflation accelerated to 8.2% in January but core inflation is more contained at 4.1%. Fitch forecasts inflation falls to 4.6% at end-2022, just above the upper bound of the National Bank of Serbia's target range, and to 3.1% at end-2023, but upside risks to our forecast have increased.

Stable External Finances: The current account deficit is projected to widen to an average 5.1% of GDP in 2022-2023 ('BB' median 2.2%) from 4.4% in 2021, partly due to strong investment growth fuelling imports. However, this is expected to remain covered by net FDI, averaging 5.4% of GDP in 2022-2023 (from 6.8% in 2021). Serbia's foreign exchange reserves were resilient to the pandemic shock, ending 2021 at 5.3 months of current external payments and we forecast a slight fall to 5.0 at end-2023, near the projected 'BB' median of 5.1 months. Net external debt fell to an estimated 31% of GDP in 2021 from 44% in 2015,

but this still compares unfavourably with the peer group median of 18%, and Fitch does not project further convergence in the coming years.

Economic Policy Continuity: President Vucic and his SNS party are set for a commanding victory in April's presidential and parliamentary elections. We anticipate consolidation of the macroeconomic policy framework, underpinned by renewal in June of the IMF Policy Coordination Instrument, but only gradual progress in structural reforms including ones to improve weak SOE governance and public sector inefficiencies. The opposition, which remains highly fragmented, has announced it will end its election boycott and contest the elections, and we consider there is a low risk of social protests undermining the stability of the administration.

Slow EU Accession Progress: Serbia opened an EU cluster in December, the first time for two years that a new chapter was opened. Fitch sees limited political impetus for substantial reform in the most problematic areas of rule of law and Kosovo, resulting in a long delay to the target accession date of 2025. Measures to tackle corruption and organised crime, improve media representation and freedom of expression, and reform the judiciary are likely to be constrained by entrenched vested interests, notwithstanding a referendum in January, in which proposals to increase the independence of judicial appointments were approved. Serbia's World Bank Governance Indicator percentile ranking has fallen to 46.8 from 50.1 over the last two years. EU accession remains an important cornerstone of government policy, but further drift could lead to a weakening over time in the still-solid public support for accession.

Sound Banking Sector Fundamentals: The non-performing loan ratio fell to 3.4% in November, from 3.7% at end-2020 (and 17% at end-2016) with a robust provisions rate, of 58%. Common equity Tier 1 capital is high at 20.6%, and around 87% of the sector (by assets) is foreign-owned, reducing contingent liability risk. Return on equity strengthened to 7.9% in 11M21, liquidity has remained adequate, and credit growth was steady at 10%, helped by extension of a credit guarantee scheme. The share of FC-denominated deposits has gradually fallen to 60% but is still well above 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 47th 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 debt and interest burdens 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, or higher external debt and interest.

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

- Public Finances: Fiscal consolidation that puts general government debt/GDP on a firm downward path over the medium term.

- Macro: An improvement in medium-term growth prospects that increase the pace of convergence in GDP per capita with higher rated peers; for example, due to structural reforms.

- 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 Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC 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.

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 below 50 for the respective Governance Indicators, this has a negative 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.