Fitch Affirms Serbia at 'BB+'; Outlook Stable

Fri 19 Aug, 2022 - 17:02 ET

Fitch Ratings - London - 19 Aug 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

Fundamental Rating Strengths and Weaknesses: Serbia's rating is supported by its credible macroeconomic policy framework, 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 euroization.

Fiscal Resilience Contributes to Stable Outlook: The Stable Outlook partly reflects the availability of external finance sources and adequacy of international reserves to absorb anticipated balance of payments pressure, and our expectation that inflation will fall in 2023. Resilient economic growth and credible fiscal policy also help anchor public finances in the face of greater spending pressures next year. Serbia's deal with Gazprom leaves its energy security less vulnerable to a scenario of a Russian shutdown of pipeline flows to Western Europe, but it is indirectly exposed to higher energy prices and weaker EU growth.

Moderate External Pressure: We project the current account deficit widens 4.7pp in 2022 to 9.0% of GDP, mainly due to energy prices, and remains high at 7.5% of GDP in 2023. Net FDI was resilient in 1H22 at 5% of GDP (annualised) from 6.8% in 2021, and is forecast at a similar level through 2023. Overall balance of payment pressure has been moderate. International reserves were EUR15.0 billion at end-July, down from EUR15.6 billion at end-February, and are projected to fall to 3.8 months of current external payments at end-2023, from 5.2 months at end-2021. Challenging external financing conditions add to external risks, although Serbia's IMF Policy Coordination Instrument (PCI) would help facilitate a funded IMF programme should one be pursued by the government. Net external debt is forecast to rise to 33% of GDP at end-2022, well above the 'BB' median of 17%.

Further Rise in Inflation: CPI accelerated to 12.8% in July, from 7.9% at end-2021, driven by higher global commodity prices and compounded by Serbian energy production disruptions, with core inflation lower at 7.5%. The National Bank of Serbia (NBS) has tightened liquidity and raised the policy rate only gradually to 3%. Increases in regulated gas and electricity prices in August and September also contribute to our forecast for inflation to remain elevated in 2022, and average 11%. We project inflation falls to 7.0% in 2023 and 3.8% in 2024, within the NBS inflation target range (3%+/-1.5pp), on the back of lower global energy prices, fading supply shock impacts, and ongoing stability of the euro/dinar exchange rate.

Steady Fiscal Deficit Narrowing: Higher inflation and imports have driven tax revenue outperformance this year, and Fitch forecasts the 2022 general government deficit falls to 3.0% of GDP, from 4.1% in 2021, in line with the government target. However, we have revised up our 2023 deficit forecast by 0.7pp to 2.5% of GDP since our last review in February, due to higher expenditure from lagged inflation-related increases to pensions and public sector wages, together with ongoing energy sector transfers. Fitch anticipates that new fiscal rules agreed with the IMF later this year will help anchor a narrowing of the general government deficit to 1.6% of GDP in 2024, which compares favourably with the peer group median of 3%.

Reduction in Public Debt: We project general government debt/GDP falls 3.4pp in 2022 to 53.7%, supported by a higher GDP deflator, and to 48.6% at end-2024, below the 'BB' median of 52.9%. The government has used 90% of its IMF SDR allocation this year (equivalent to 1.2% of GDP) and we assume continued reliance on the domestic debt market, with no new Eurobond issuances in 2022. The average maturity of central government debt has lengthened to 8.3 years at end-June from 6.8 years at end-2021, but the foreign-currency share of public debt rose 3.6pp to 75.1%, and is well above the peer group median of 57.3%.

Relatively Resilient Growth: Fitch forecasts GDP growth of 3% in 2022, slowing from 4.2% (annualised) in 1H22, due to a weakening of external demand and of real wage growth. Although Serbia's exports to Russia and Ukraine are only 4% and 1% of the total, respectively, it is a net energy importer and has some sanctions exposure through Russian holdings in the Serbian energy sector. Serbia's gas pipeline infrastructure, the recent three-year deal with Gazprom covering the majority of its gas needs, and its cooperative relationship with Russia mitigate energy security risks in the event of a shutdown of pipeline flows to Western Europe, but it is indirectly exposed to higher global energy prices. We project GDP growth picks up to 3.3% in 2023 but is subject to sizeable downside risks from weaker-than-expected EU growth and energy supply shocks, and to 3.6% in 2024, close to our assessment of Serbia's trend rate.

Policy Continuity: Fitch anticipates a consolidation of the macroeconomic policy framework but only gradual progress in structural reforms, following April's re-election of President Vucic and his SNS party winning 48% of parliamentary seats. We expect a new SNS-led coalition will be formed in September and comprise a greater number of parties but again including the Socialist party, and that its broader composition will have little impact on policy direction. The opposition ended its election boycott and there were no widespread social protests, which could help arrest the slide in Serbia's World Bank governance percentile score to 46.8 from 50.1 over the last two years.

Geopolitics Further Complicates EU Accession: Serbia's neutral position on the Russia-Ukraine war represents a further challenge to its already slow EU accession process. Over time, there is likely to be somewhat greater EU pressure for the Serbian government to harden its stance on Russia. However, the recent gas contract agreed with Gazprom at favourable prices underlines Serbia's significant economic reliance on Russia. We see limited political impetus for reform in the other problematic EU areas of rule of law and the relation with Kosovo, which has further deteriorated this year. While EU accession will likely remain an important cornerstone of the new government, a continuation of the weakening of public support for the EU in recent months could potentially contribute to further policy drift.

Sound Banking Sector Fundamentals Preserved: The banking sector weathered the pandemic well and has limited direct exposure to Russian banks. The common equity Tier 1 ratio was a still high 18.9% at end-May 2022, liquidity has remained adequate, and return on equity, at 10.8%, has recovered to pre-pandemic levels. 84% of the sector (by assets) is foreign-owned, reducing contingent liability risk, but the share of FC-denominated deposits at 64% is well above the 'BB' median of 18%. The non-performing loan ratio fell further to 3.3% in May (compared to 17% at end-2016) with a healthy provisions rate, of 57%, and credit growth was stable at 12.8% yoy in June.

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:

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

- Macro: Severe shock to economic growth, for example from recession in the EU, markedly lower FDI, and/or energy shortages potentially resulting from an unexpected deterioration in relations with Russia or from the impact of tighter EU sanctions on Russian ownership of Serbia's energy sector.

- 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.

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.