FITCH AFFIRMS SERBIA AT 'BB+'; OUTLOOK STABLE

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Fitch Ratings - London - 17 Feb 2023: 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

Rating Fundamentals: 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-denominated public debt and higher net external debt than peer group medians, as well as a high degree of banking sector euroisation. Exchange rate stability underpinned relative macroeconomic stability in 2022 despite the shock of the war in Ukraine, but geopolitical risks linger.

Resilient External Position: FX reserves increased in 2022 to an all-time high of EUR19.5 billion at end-December, despite a sharp energy-driven deterioration in the current account balance, demonstrating resilience to the confidence shock from the war in Ukraine. The current account deficit widened to 7% of GDP in 2022 from 4.3% in 2021 almost entirely driven by a widening of the trade deficit caused by higher energy imports. This was fully financed by net FDI inflows and bolstered by funds from the UAE and a new IMF programme.

Stable Balance of Payments Outlook: Fitch expects balance of payment trends to support continued exchange rate stability throughout the forecast period to end-2024. We expect the current account to narrow to an average of 6% of GDP in 2023-2024 as energy import volumes fall, reflecting the stocks built during 2022, and prices ease, particularly in 2024. FDI flows will remain robust and support further export expansion, while IT services will benefit from the inflow of Russians enhancing an already buoyant domestic sector. A Eurobond issue in January raised USD1.75 billion, lifting reserves to EUR20.9 billion at the end of the month. A further modest nominal increase is expected, keeping reserves at around 4.7 months of current external payments, in line with the 'BB' median.

Energy Costs Dent Fiscals: The general government deficit was 3.1% of GDP in 2022 compared with the target of 3.9% in the revised budget adopted in November and a 4.1% deficit in 2021. This was largely driven by the impact of inflation on tax revenue and contained current expenditure growth and came despite net lending of around 1.8% of GDP to cover losses in the energy sector. The 2023 budget anticipates smaller energy-related transfers, and Fitch assumes that retail price hikes for gas and electricity together with cautious revenue assumptions mean the deficit will fall to 2.7%.

Declining Debt/GDP Trend: A further decline in commitments for the energy sector and a reviving economy will pull the deficit down to 1.4% of GDP. Continued primary surpluses will lower general government debt from to 55.7% of GDP in 2022 to 50.5% in 2024, below the forecast 'BB' median of 55.0%. Medium-term fiscal dynamics should be underpinned by a new fiscal rule.

External Demand Hits Growth: Fitch projects real GDP growth of 1.8% in 2023, from 2.3% in 2022, reflecting the low carry over from 4Q22 and ongoing weakness in export markets, although FDI-supported real export growth will continue. Domestic demand will remain the main source of growth reflecting the

strong labour market, and growth should be bolstered by the potential normalisation of the agricultural season and electricity production. Growth is forecast to revive to 3.8% in 2024 as monetary policy is eased, lower inflation reduces pressure on disposable incomes and external conditions improve.

Inflation Close to Peak: Headline inflation looks set to peak in 1Q23 after reaching an 11-year high of 15.1% in December, and is high relative to rating peers ('BB' median 7.4%). Food and energy prices have accounted for the bulk of the rise in inflation over the past 18 months and a hike in household electricity and gas prices will push the headline rate up. Core inflation was well below headline inflation, at 10.1% in December, reflecting exchange rate stability and a 450bp tightening of the main monetary policy rate.

Tighter monetary policy and base effects should pull headline inflation back into single digits by the end of the year. Private sector wages are running above inflation, but seemingly consistent with a rise in productivity. Financial and corporate sector inflation expectations appear anchored, at 4% and 5%, respectively, for the three years ahead.

Possible EU Accession Momentum: Approval of a new French/German proposal to stabilise relations with Kosovo would give impetus to EU accession talks. It could also ease pressures caused by Serbia's neutral position on the war in Ukraine, although Serbia will remain reliant on Russian gas for at least another three years. Fitch considers that EU accession remains a key policy anchor for the government. Any agreement on Kosovo is necessary, but not sufficient, for progress given EU concerns about the rule of law. However, a more severe dislocation of the process could negatively impact foreign investment, although this is not our base case. Governance, as measured by the World Bank, is just below the 'BB' median.

Resilient Banks: Banks have smoothly weathered the shock of the war. Capital adequacy has strengthened, to 19.5% at end-3Q22, and the non-performing loan ratio was at an historical low of 3% at end-2022 (with coverage of 58%). Retail depositors have rebuilt dinar savings after a drop in March, although the share of foreign-currency deposits, at 61% of the total, is well above the peer median of 19%. 84% of the sector (by assets) is foreign-owned, reducing contingent liability risk.

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: A fiscal stance 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 that enhance economic governance.

-External Finances: Reduction in external vulnerabilities; for example, from 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.