## Fitch Affirms Serbia at 'BB+'; Outlook Stable

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Fitch Ratings - London - 11 Aug 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 than peer group medians, as well as a high degree of banking sector euroisation. Much improved energy dynamics have strengthened the external position, underpinning exchange rate stability, and improved public finances in 2023, but geopolitical risks linger.

Stronger External Position: FX reserves have risen due to the easing of the energy sector pressures, continued strong net FDI inflows and export growth. Reserves were EUR24.8 billion at end-May, up from EUR22 billion at end-2022, supporting stability of the dinar against the euro. Fitch expects the improvement of the energy balance to drive a narrowing of the current account deficit (CAD) to 3.1% of GDP in 2023 from 7% in 2022.

From 2024, the CAD will widen slightly as energy gains ease and multi-year construction projects feed into the import bill. Services growth should remain solid, but current transfers are likely to ease after being distorted by flows from Russia in 2022. Net FDI inflows will fully cover the CAD, allowing a further nominal increase in reserves through 2025. Reserves are projected to remain around 5.2 months of current external payments in 2023-2025 ('BB' median 4.3 months).

Lower Energy Costs Boost Budget: Public finances have performed much better than budgeted, prompting the government to introduce additional spending measures. Over 1H23, the general government posted a surplus of 0.6% of GDP, compared with an initial full year budgeted deficit of 3.3% and a deficit of 0.3% in 1H22, owing to much lower than budgeted spending on energy-related costs and revenue outperformance, reflecting a strong labour market and high corporate profits.

The new spending package, costing around 0.9% of GDP, can be comfortably absorbed but elements of its design and implementation (such as increased spending on pensions) have been questioned by independent observers.

Debt/GDP on Downward Path: Fitch expects the strong revenue performance (and savings on energy-related spending) to narrow the deficit to 2.7% of GDP in 2023. A deficit of 2.2% of GDP is targeted for 2024 owing to a further reduction in support for the energy sector, strengthening economic growth and increases in to excise duties worth 0.4% of GDP.

Fitch assumes fiscal performance will be broadly in line with government targets in both 2024 and 2025 (target deficit 1.5% of GDP), supported by structural measures to enhance revenue collection. This will underpin a further fall in government debt from 55.7% at end-2022 to GDP to 48.1% of GDP by end-2025, when the 'BB' median is projected to be 52.4%. 71% of public debt is foreign-currency denominated, compared with the 'BB' median of 55%.

Improved Energy Dynamics: Energy sector dynamics have improved significantly. This reflects a combination of reform measures and favourable exogenous factors. Domestic energy production has recovered after disruptions in late-2022 and through 2023, largely reflecting improved weather conditions. Lower domestic consumption in response to tariff increases allowed the resumption of electricity exports, enhancing the financial position of state power utility Elektroprivreda Srbija. Tariff increases and much lower international energy prices have supported the financial position of state gas utility Srbijagas.

Structural measures to tackle energy vulnerability are a key objective of the IMF programme and risks to the fiscal and balance of payments positions would re-emerge if exogenous factors become less favourable.

Growth Picking Up: Economic activity has begun to pick up after a subdued few quarters. The flash reading put real GDP growth at 1.7% yoy in 2Q23, up from 0.7% in 1Q23. Growth should strengthen over the remainder of the year as real incomes return to positive territory. Net trade will remain supportive as FDI recipients step up exports, while weather conditions will support the agricultural sector, where output prospects have improved after two years of drought, despite heavy rains.

Rapid growth in the ICT sector should continue, although the pace may ease after an inflow of Russia workers boosted output from the sector last year. Fitch projects real GDP growth of 2.4% in 2023, picking up to 3.4% in 2024, supported by higher real wages and strengthening activity in key export markets.

Inflation Past Peak: Inflation has passed its peak, as the jump in fuel prices drops from the annual comparison, and is set to return to single digits by the end of the year owing to base effects. Fitch anticipates further monetary policy tightening, which combined with base effects will keep inflation on a downward path. However, the pace of decline will be tempered by planned energy price hikes in November (10% for gas and 8% for electricity) agreed with the IMF. Fitch expects inflation to remain above 'BB' peers, averaging 12.6% in 2023, 5.6% in 2024 and 4% in 2025 (within the 3% +/-1.5pp official target).

Resilient Banks: The banking sector continues to demonstrate resilience. Capital adequacy strengthened to 22.4% at end-2Q23, when the non-performing loans ratio was close to an historical low, at 3.2%. Stage two loans are not rising notably, despite the weaker economy and higher interest rates. The easing of various regulatory support measures in 2022 has been extended into 2023, but take-up is reported as low and the authorities plan the unwinding of the measures at the end of the year.

The increase in retail deposit dollarisation that occurred at the start of the war in Ukraine has been reversed and a new policy to increase corporate dinarisation took effect from 1 July, although deposit dinarisation remains low, at 40% in mid-2023.

Setback in Kosovo Relations: Prospects for progress in the normalisation of relations with Kosovo in the near term have dampened. Relations with Kosovo are a stumbling block for Serbia's EU accession, but progress in other areas is also necessary, and this continues to edge forwards. The standing of the ruling party has not been dented, despite widespread demonstrations after two mass shootings on consecutive days in May. Fitch assumes it will secure a further term in office should snap elections be held next year. Governance, as measured by the World Bank, is just below the 'BB' median.

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 sharp fall in FX reserves, or higher external debt and interest costs.

-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.

-Macro: Persistent weakening of economic growth, for example, from markedly lower FDI or a prolonged increase in geopolitical risk.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-Public Finances: A marked reduction in general government debt/GDP reflecting, for example, a persistent narrowing of the general government deficit.

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

-External Finances: A sharp improvement in the external balance sheet.

**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.

**COUNTRY CEILING**

The Country Ceiling for Serbia is 'BBB-' 1 notch above the LT FC IDR. This reflects the absence of material constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of 0 notches above the IDR. Fitch's rating committee applied a +1 notch qualitative adjustment to this, under the Long-Term Institutional Characteristics pillar, reflecting the importance of FDI to Serbia's large open economy and the requirements of EU accession.

**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.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores.