RATING ACTION COMMENTARY

Fitch Affirms Serbia at 'BB+'; Outlook Stable

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Fitch Ratings - London - 09 Feb 2024: 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 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. Serbia has weathered the impacts of the regional energy crisis and associated macroeconomic fallout well, but geopolitical risks linger.

Resilient Economic Growth: Preliminary data put economic growth in 2023 at 2.5%, driven by net trade and investment. Real exports rose owing to new FDI-financed capacity coming on stream and a diversification of export markets. Investment growth stemmed from infrastructure projects and real estate development. A recovery in the agricultural sector (9% growth) due to favourable weather after two years of drought also supported growth. Domestic demand should be the main source of growth in 2024 and 2025. Private consumption will benefit from continued growth in real wages and further increases in employment.

High Investment: Investment will remain strong as work ahead of Expo2027 (hosted by Belgrade) continues. FDI-financed projects will lift exports, as will the recovery in EU demand, although this will be offset by the import intensity of construction and infrastructure projects. Investment/GDP is forecast at around 26.5% in 2024 and 2025, up from 18.2% between 2010 and 2019. Fitch forecasts growth of 3.3% in 2024 and 4.2% in 2025. Nearshoring, the free-trade agreement signed with China in September, the EU's new Western Balkans growth plan and the infrastructure associated with the Expo may all support stronger medium-term growth (official estimated at 4%).

Strengthening External Position: FX reserves climbed by 20% in 2023 to EUR27.9 billion (equivalent to 5.7 months of current external payments; 'BB' median 4.5). This was driven by a sharp energy-related narrowing of the current account deficit (CAD) and record net FDI inflows. Fitch estimates a current account deficit of 2.1% of GDP, down

7% in 2022, owing to much lower imports (largely energy-related) and higher exports, led by manufactured goods. Net services also performed strongly, rising by 39% owing to higher tourism, ICT and transport credits. However, this was outweighed by higher net primary income outflows reflecting foreign investors' profit repatriation.

Further reserve accumulation is anticipated over the forecast period. Net FDI inflows will remain strong and sufficient to cover the CAD. The CAD is forecast to widen, reflecting imports required for capex and the Expo, which will more than offset the boost to exports from improved growth in key trading partners. Continued expansion of the services balance is expected driven by the ICT sector, although outflows of profit transfers will also rise in line with the ongoing FDI inflows. Net external debt will remain on its long-term downward trajectory and at 14.6% of GDP in 2025 will be broadly in line with the forecast peer median.

Falling Government Debt: The general government deficit is officially estimated at 2.2% of GDP, comfortably inside the revised target of 2.8% (revised from an original 3.3%). The improvement against the original budget reflects much lower transfers to energy SOEs, which were less than half the budgeted level, and accommodates ad hoc salary and pension increases a few months before the elections.

The deficit is forecast to narrow to 1.4% in 2024 due to the strengthening economy and gains from improved revenue collection. We expect Expo financing to push the deficit to 1.7% in 2025. Fitch's deficit projections are consistent with debt remaining on a downward trend and we forecast debt/GDP at 48.4% at end-2025 (protected 'BB' median 50.2%).

Elections Strengthen Ruling Party: The ruling SNS party of president Vucic won the parliamentary elections in December, increasing its share of the vote from the April 2022 polls and securing a small overall majority. The election conduct was criticised by external observers and there were also reports of irregularities on the day. Fitch does not expect the elections to lead to any change in policy. New parliamentary elections are not due until December 2027, but there has been a recent tendency for snap elections. With attention focussed on the Expo, the current parliament may have greater longevity. Relations with Kosovo remain a stumbling block for EU accession.

Solid Banks: The 76% foreign-owned banking sector remains healthy. At end-September capital adequacy was 22.2%, up from 20.2% at end-2022 and non-performing loans stood around their long-term low at 3.1% and fully covered by provisions. The central bank introduced an untargeted cap on mortgage loan rates in September owing to some pressure on the housing loan portfolio as interest rates picked up (mortgages are indexed to EURIBOR). Banks have been able to absorb this in their profits and still record a return on equity of 18.2%.

Dinarisation has resumed its upward trend after disruption by the outbreak of the war in Ukraine. Corporate and household deposit dinarisation was 44.6% at end-2023, up from 39% at end-2022. Local currency savings grew rapidly last year but from a much lower

base. Credit contracted by 10.2% in real terms owing to higher interest rates and the repayment of pandemic-related facilities that led to a fall in corporate loans.

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.

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

-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.

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.

-Structural: An improvement in governance potentially incorporating steps that would smooth EU accession prospects.

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 open economy and the EU accession process.

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.