Fitch Revises Serbia's Outlook to Positive; Affirms at 'BB+'

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Related Content:

Serbia - Rating Action Report

Fitch Ratings - London - 09 Aug 2024: Fitch Ratings has revised the Outlook on Serbia's Long-Term Foreign-Currency Issuer Default Rating (IDR) to Positive from Stable and affirmed the IDR at 'BB+'.

A full list of rating actions is at the end of this rating action commentary.

Key Rating Drivers

The revision of the Outlook on Serbia's IDRs reflects the following key rating drivers and their relative weights:

Medium

Strengthening Credit Fundamentals: We expect Serbia to keep government debt/GDP on a downward path and maintain a solid external position amid an investment boom that will bolster growth prospects in the near term and, potentially, the medium term. Fitch has revised up its fiscal deficit forecasts due to higher public investment, but it has greater clarity on the fiscal implications than at the time of our last review in February.

Since we upgraded Serbia to 'BB+' in 2018, the economy has been resilient to the pandemic and energy shock, which was exacerbated by failings at SOEs that are being addressed. The authorities have demonstrated strong compliance with, and appear committed to, a reform agenda anchored on IMF programmes and policy framework underpinned by sustained exchange rate stability.

Investment to Drive Growth: Growth prospects are robust and will be led by a large pipeline of public and private investment. The "Leap into the Future - Serbia Expo 2027" plan contains EUR17.8 billion (23.4% of projected 2024 GDP) of spending centered on the 2027 Belgrade Expo. The expo itself (including rail link) accounts for EUR1.3 billion. The rest is largely road and rail, industrialization and other infrastructure projects. The authorities have a reasonable record of project execution, although handling a pipeline of this magnitude could pose challenges. FDI-driven projects and linkages to the EU market will underpin solid private investment growth, with large manufacturing projects ongoing.

Growth Above Trend: Private consumption growth should remain solid due to the expected continued strength of the labour market. Net exports will be negative given the high import bill, but new capacity and the strengthening of the eurozone economy will support export growth. Fitch forecasts growth of 3.8% in 2024. Trend growth is estimated by the authorities and IMF at 4%. Successful implementation of infrastructure projects may provide some upside. Fitch expects growth to be above trend in 2025 and 2026 due to high investment. Solid growth and exchange rate stability underpin our forecast of a near doubling of GDP per capita in US dollar terms between 2018 and 2026.

Falling Government Debt: Debt/GDP is projected to fall despite capex-driven upward revisions to official deficit targets. The general government balance was in a small surplus in 1H24 due to revenue outperformance, but the government has maintained the 2024 deficit target of 2.2% of GDP. Given the likely continued revenue buoyancy and capex execution challenges, Fitch expects a deficit of 1.9%. Official 2025 and 2026 deficit targets were raised by 1% and 0.8%, respectively, almost entirely due to capex, which is budgeted to average 7.4% of GDP over 2024-2027. The targets breach the new fiscal rule (as did the ad hoc pension increase in 2023) but have been agreed to by the IMF.

The modest increase in capex relative to the headline size of the plan reflects that most projects were already captured in official projections. However, tying them to a specific date could bring implementation challenges and cost overruns. Nonetheless, Fitch forecasts deficits of 2.5% of GDP in 2025 and 2026, reflecting ongoing commitment to debt/GDP reduction, albeit more slowly than previously anticipated. Fitch forecasts general government debt/GDP at 48.8% of GDP at end-2026 from 52.3% at end-2023. Our projections are consistent with debt/GDP falling by 2.9pp between 2018 and 2024, despite intervening shocks, compared with an increase of 12.2pp for the 'BB' median.

Strengthened External Position: The external position has continued to strengthen as net FDI inflows more than fully covered the widening current account deficit. Balance of payments data for 5M24 show a current account deficit of EUR0.9 billion (1.2% of Fitch-projected full-year GDP) and net FDI inflows of EUR1.7 billion. Central bank purchases to offset exchange rate appreciation pressure and a USD1.5 billion Eurobond issued in June lifted total reserves to EUR31.1 billion at end-July, up EUR3.2 billion since the start of the year.

FDI Covering CAD: Fitch expects the investment-driven rise in the import bill will widen the current account deficit to 4% of GDP in 2024, 5% in 2025 and 5.3% in 2026. Net FDI inflows will fully finance the 2024 and 2025 deficits and portfolio inflows will more than cover the remaining gap in 2026, allowing an increase in reserves in each year. The rising import bill means that reserves to current external payments (CXP) will peak at 6.3 months in 2024 ('BB' median 4.5) before falling to 5.8 months in 2026. Current account deficits have been fully FDI-financed each year since the 2018 upgrade, when reserves were EUR12.9 billion (4.6 months of CXP).

Inflation Back to Target: Inflation returned to the central bank's target range of 3+/-1.5% in May (3.8% in June), reflecting lower food prices, energy price hikes dropping out of the annual comparison, lower imported inflation, easing real wages and tighter monetary policy. Fitch forecasts inflation to average 4.4% in 2024. Average inflation is projected at 3.6% in 2025 and 3.2% in 2026. This is consistent with further central bank policy rate cuts following two 25bp moves in June and July. Monetary policy pass-through has been effective despite still elevated levels of dollarisation (57% for deposits), which remain a rating weakness.

Serbia's 'BB+' IDRs also reflect the following key rating drivers:

Governance: Governance indicators, as measured by the World Bank, are slightly better than the 'BB' median, but well below that of 'BBB' sovereigns. Local elections in June confirmed the dominance of the ruling SNS-led coalition, and we expect President Vucic to serve a full term to end-2027, with the Expo the key focus. Relations with Kosovo remain tense and a constraint on Serbia's progress with EU accession. The strength of relations with China was highlighted by a visit from President Xi in May.

Sound Banking Sector: The majority foreign-owned banking sector remains healthy. Key indicators changed little over the first five months, with capital adequacy just over 21% and non-performing loans just over 3%. Profitability indicators are strong and well above medium term averages, reflecting high net interest margins. Credit growth is starting to revive in line with higher demand and easing lending standards.

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: An increase in general government debt/GDP, for example, due to a structural fiscal loosening and/or substantial capital spending overruns.

-Macro: Weaker 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 narrowing of the general government deficit that supports further reduction in general government debt/GDP.

-Macro: Continued robust GDP growth that supports ongoing convergence in GDP per capita with higher rated peers.

-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 no 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 track record of 20 years without a restructuring of public debt and captured in our SRM variable, this has a positive 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.