Fitch Affirms Serbia at 'BB-'; Outlook Negative

Fitch Ratings-London-28 October 2009: Fitch Ratings has today affirmed the Republic of Serbia's Long-term foreign and local currency Issuer Default Ratings (IDRs) at 'BB-', with Negative Outlooks. At the same time, the agency affirmed the Short-term foreign currency IDR at 'B' and the Country Ceiling at 'BB-'.

"The stabilisation of external economic and financial conditions and a EUR3bn IMF programme have helped buttress confidence in Serbia following a period of severe stress in Q4 2008," said David Heslam, Director in Fitch's Sovereign team. 'However, the extent of the recession, sizeable external financing requirements, currency-linked credit risks in the heavily euroised banking sector, deteriorating public finances and uncertainty over the government's ability to consistently tighten fiscal policy to remain on track with its IMF programme mean that risks remain on the downside."

Serbia's substantial current account deficit (CAD) of 17.4% of GDP in 2008 left it particularly vulnerable to the global financial crisis. The reduced availability of private external capital flows to fund a deficit on this scale triggered a sharp economic adjustment. Fitch forecasts real GDP to contract 4.5% in 2009 and a further 1% in 2010. Reflecting weaker domestic demand, Serbia's CAD is forecast to narrow to 7.9% of GDP this year and 7.2% in 2010, which remains high compared with a forecast median CAD of about 3% for sovereigns rated in the 'BB' range. Serbia's gross external financing requirement (GXFR, CAD plus maturing medium- and long-term external debt) will also remain large compared with rated peers. This principally reflects increased private sector amortisation following a sharp rise in private external debt in recent years (USD22.5bn in at end-2008 compared with USD3.2bn at end-2003), driven predominately by the non-bank private sector. Fitch forecasts Serbia's GXFR at 71% of official reserves in 2009, before falling to 57% in 2010. This compares with a median GXFR for sovereigns rated in the 'BB' range of about 45%.

Encouragingly, rollover rates on Serbia's maturing external debt have held up well, aided by a commitment by parents of Serbia's largely foreign-owned banking system (three-quarters of system assets) to maintain exposure to the country and support their subsidiaries. Fitch also considers the IMF programme to be an important anchor to investor confidence, underpinning willingness to roll over the non-bank private sector's external obligations and domestic depositor confidence in the banking system and currency. In Fitch's opinion, a failure to remain on-track with the IMF could undermine this confidence, with the potential to intensify economic and financial instability in Serbia and place renewed pressure on the currency and foreign exchange reserves, which would be negative for creditworthiness.

Fitch forecasts the general government deficit at 4.5% in 2009, in line with a widened deficit target agreed with the IMF. Negotiations with the IMF over the 2010 general government deficit target have, however, proved more problematic, with the Fund delaying its second review in September 2009 to give the government time to identify further savings. Fitch forecasts a general government deficit of 4% in 2010, while noting downside risks to meeting this target in light of the weak economic backdrop and narrowing tax base. While the government has successfully lined up additional sources of bilateral and multilateral financing, the limited domestic financing base is a relative weakness compared with some 'BB' range credits. Fitch is also concerned that non-compliance with IMF fiscal targets could put at risk some budget financing from other multilateral institutions.

Serbia's high income level and strong institutional and development indicators relative to 'BB' range peers are underlying supports to creditworthiness. In contrast with the private sector, the sovereign's external debt service burden is moderate and government debt levels are in line with peers. While the economic backdrop has led to an increase in non-performing loans (to 9.7% in June 2009, from 5.3% at end-2008), strong prudential policies mean the banking system has strong capital ratios (21.2% in June 2009) and the sovereign has not been forced to provide direct financial support. The risk of a destabilising political shock has receded following the passing of Kosovo's declaration of independence and the 2008 election of a pro-EU government. Legal and economic integration with the EU is progressing, although full EU membership remains a distant prospect.

Source: Fitch Ratings.