Fitch Revises Serbia's Outlook to Stable; Affirms 'BB-'

Fitch Ratings-London-11 November 2010: Fitch Ratings has revised Serbia's Outlooks to Stable from Negative. Its ratings have been affirmed at Long-term foreign- and local currency Issuer Default Ratings (IDR) 'BB-' respectively, Short-term local currency IDR 'B' and Country Ceiling 'BB-'.

"The revision of Serbia's Outlook reflects the reduced risk of an external financing crisis, the resumption of economic growth and the government's plans for medium-term fiscal consolidation," says Charles Seville, Director in Fitch's Sovereign team.

External finances remain a weakness, though risks have receded compared with the onset of the global financial crisis. Serbia's current account deficit has narrowed, IMF balance of payments support under the stand-by arrangement has helped bolster reserves and investor confidence while foreign-owned banks have maintained exposure to Serbia. Although the latest IMF review has been delayed, Fitch does not expect a permanent breakdown in the relationship.

Fitch forecasts a current account deficit of 9% of GDP in 2010, compared with 18% in 2008, though it expects it to narrow only gradually through 2012. Net external debt of 93% of current account receipts (CXR) is well above the 'BB' median and the debt service ratio is high at 33% of CXR. However, the increase in FX reserves and reduction of short-term debt has lowered Serbia's gross external financing requirement to 52% of reserves in 2010, well below pre-crisis levels.

Macroeconomic stability remains relatively fragile in Serbia, as evident in currency volatility, a continued high and volatile inflation rate and high levels of euroisation. Stabilising the currency, which has depreciated 11% against the euro so far in 2010, and inflation expectations, remains important for improving confidence. The National Bank of Serbia (NBS) has raised interest rates by 250bps since July 2010 in pursuit of its inflation target and has also periodically intervened in the foreign exchange markets to support the dinar. Fitch forecasts Serbia to grow 1.5% in 2010 and 3% in 2011, a relatively weak recovery.

The fiscal deficit is forecast to widen in 2010 to an estimated 4.8% of GDP, in line with the target agreed with the IMF. However, the government has laid the foundations for lower deficits in the future. New fiscal rules aim to gradually reduce the fiscal deficit to a medium-term target of 1% and keep public debt below 45% of GDP. The new law also introduces a new indexation mechanism to reduce the burden of pensions and public sector wages, which account for more than half of the budget.

Although the general government debt has increased, at 40% of GDP it is in line with that of 'BB' range peers, and debt repayments are below the 'BB' median. However, debt is largely in foreign currency, increasing balance sheet risks. Domestic local currency financing is limited to relatively costly short-term borrowing on the T-bill market, although the Finance Ministry is working to develop the market.

Firm prudential requirements have contained the impact of deteriorating asset quality on the banking sector. Banks remain profitable, liquid, and highly capitalised. NPLs have risen to 17% of total lending but are 149% provisioned. IMF stress tests show banks are robust to further shocks. A fall in deposits

during the global financial crisis in late 2008 was fully recovered over the course of 2009 and banks weathered the euro area financial turbulence in April/May 2010.

Political risk weighs on Serbia's ratings. The ruling pro-EU coalition has a narrow parliamentary majority and faces legislative and presidential elections in 2012. This could hamper the implementation of reforms and deficit reduction. Relations with the EU are strengthening but full membership remains distant and faces a number of obstacles. The accession process, as in other transition countries, should align economic and legal structures more closely with those of the EU, improve growth prospects and anchor political stability.

Serbia's sovereign ratings are supported by its relatively rich economy - GDP per capita of USD5,690 is well above the 'BB' range median - and human development indicators. Governance indicators for Serbia published by the World Bank are broadly in line with peers and the business environment is slightly better.

Intensified balance-of-payments pressures that led to a sustained fall in official foreign exchange reserves would create downward pressure on the ratings. Similarly, material slippage in the government's fiscal consolidation programme or a rise in political risk - although not Fitch's central scenario - could also lead to negative pressure on the ratings. A balanced and sustainable economic recovery, continued structural reforms, a narrowing of the twin deficits and declining external debt ratios, would put upward pressure on the ratings over the medium term.

Source: Fitch Ratings.