FITCH UPGRADES SERBIA TO 'BB-'; OUTLOOK STABLE

Fitch Ratings-London-17 June 2016: Fitch Ratings has upgraded Serbia's Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) to 'BB-' from 'B+'. The Outlooks are Stable. The issue ratings on Serbia's senior unsecured Foreign- and Local-Currency bonds have also been upgraded to 'BB-' from 'B+'. The Country Ceiling has been revised up to 'BB-' from 'B+'. The Short-Term Foreign Currency IDR has been affirmed at 'B'.

KEY RATING DRIVERS

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

MEDIUM

Fiscal consolidation and moderate real GDP growth rates will continue in the coming years, keeping the fiscal deficit at around 3% of GDP from 2017 and putting the government debt to GDP ratio on a downward path. The fiscal deficit narrowed to 3.8% of GDP in 2015, a significant improvement on the 6.6% posted in 2014. This partly relied on one-off factors. However, the underlying improvement in the deficit is estimated at around 2.5 percentage points. This came from reductions in pension payments and salaries on the expenditure side (around 1.5 percentage points), and higher economic growth on the revenue side (around 1 percentage point).

Fiscal trends in the first few months of 2016 have been positive, and we now expect a general government deficit this year of 3.3% of GDP, compared with 4.0% previously. Fitch expects the public debt/GDP ratio to peak at around 77% of GDP in 2016, before falling to 74% by 2018.

The economy returned to growth in 2015, expanding by 0.7%. Growth was driven by investment and net exports. In 1Q16 the economy expanded by 3.5% year on year, the fastest rate since 2013. Although a higher base in 2H16 will prevent this rate of expansion being sustained, we now expect full-year growth of 2.4% in 2016, up from 1.7% previously. Growth will again be driven by investment and net exports.

Serbia's external balances are continuing to improve. The current account deficit narrowed to 4.8% of GDP in 2015, down from 11.6% in 2012. The increase in export capacity - driven primarily by strong inflows of foreign direct investment (FDI) - has been particularly significant in this. Net FDI inflows comfortably covered the current account deficit in 2015. The strength of net FDI inflows points to improvements in the business environment. Serbia moved up nine notches in the World Bank's 2016 Doing Business Survey.

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

Serbia's 'BB-' Long-term IDRs are supported by income per head above 'BB' median, superior human development, and the formal opening of EU accession chapters. The banking sector is stable and well capitalised. Governance is high and improving relative to peers. Measures of political stability, government effectiveness as well as regulatory quality have also improved.

The government's commitment to reform appears to be strong, with the three-year IMF Stand-By Arrangement (IMF SBA) acting as a powerful policy anchor. The first three reviews under the IMF SBA signed in 2015 proceeded smoothly. However, some of the most challenging IMF-mandated reforms, notably reform of SOEs, the resolution of strategic public enterprises that have been protected from creditors, and the "rightsizing" of the public sector workforce, are still ahead. The political environment is likely to remain fairly stable. The snap election held in May 2016 was comfortably won by the incumbent Serbian Progressive Party, led by Prime Minister Aleksandar Vucic. Fitch expects the next government's composition to be broadly similar to that of its predecessor.

At 76.8% of GDP in 2015, Serbia's public debt level is well above the 'BB' median (39.8% of GDP). 71.1% of public debt is denominated in foreign currency, mostly euro, exposing the level to currency risk. However, a low government interest-to-revenue ratio, a large concessional component of debt and a broader and less volatile revenue base compared with peers mitigates risks associated with the high debt burden. Moreover, at USD12,150, Serbia's gross national income per capita (in purchasing power parity terms) is above the 'BB' median (USD10,892), indicating greater debt tolerance. The ultra-loose monetary policy by the European Central Bank provides an important anchor for yields on Serbian public debt.

Net external debt rose to 28.8% of GDP in 2015, up from 25.2% in the previous year and above the 'BB' median. However, Fitch forecasts that net external debt will fall to 24.3% of GPD by 2018 as a result of lower current account deficits and continued strong net FDI inflows.

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 FC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:
- Macro: -1 notch, to reflect weak medium- and long-term growth potential relative to ratings peers.

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.

RATING SENSITIVITIES

The Stable Outlook reflects Fitch's assessment that upside and downside risks to the rating are currently balanced. The main factors that could, individually or collectively, lead to positive rating action are:

- A rise in Serbia's medium-term growth prospects as a result of structural reforms.

- A material reduction in the general government debt/GDP ratio.

- A further narrowing of the current account deficit and/or higher net FDI inflows, leading to a reduction in net external debt.

The main risk factors that could, individually or collectively, trigger negative rating action are:

- A reversal of fiscal consolidation, or the materialisation of large contingent liabilities on the government's balance sheet, that puts the debt/GDP ratio on an upward path.

- A recurrence of exchange rate pressures leading to a fall in reserves and a sharp rise in debt levels and the interest burden.

KEY ASSUMPTIONS

Fitch assumes that the government will maintain its proposed reform and fiscal consolidation agenda, in line with the IMF agreement.

Source: Fitch Ratings.