Fitch Affirms Serbia at 'BB-'; Stable Outlook

Fitch Ratings-London-09 November 2011: Fitch Ratings has affirmed the Republic of Serbia's Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BB-'. The Outlook on the Long-term IDRs are Stable. The agency has also affirmed the Short-term foreign currency IDR at 'B' and the Country Ceiling at 'BB-'.

"Declining inflation and relative dinar stability point to underlying gains in macroeconomic stability in 2011, but the eurozone crisis has weakened the external financing and growth outlook, which will also add to pressures on the budget in the run-up to the elections," says Michele Napolitano, Associate Director in Fitch's Emerging Europe Sovereigns Team.

External finances remain a key issue for the credit rating, although risks have receded since the onset of the global financial crisis in 2008. Fitch expects the net trade performance to keep the current account deficit below 8% of GDP in 2011 and 2012, down from 21% in 2008, reflecting the rebalancing of the economy towards more export-oriented growth. The quality of external financing has markedly improved since the crisis with foreign-direct investment now concentrated in the tradable sector and accounting for around 54% of current account coverage in 2011.

Fitch forecasts that the general government fiscal deficit will narrow to 4.3% of GDP in 2012, down from 4.5% of GDP in 2011. There will be increased pressure on the budget in the run-up to the elections and in the wake of the recently approved decentralisation law, although Fitch expects any potential slippage to be contained and the deficit to stay within the limit set by the fiscal rule.

The agency estimates government debt will exceed the 45% of GDP limit in 2012. In September 2011 public debt stood at 44.4% of GDP, according to the Serbian Law on Public Debt methodology (42% of GDP according to Maastricht criteria). This is close to the 45% of GDP limit set by the fiscal rule and the 'BB' median of 40%. The rule may therefore face an early test. The government debt's foreign-currency exposure is high and makes public debt dynamics sensitive to exchange rate volatility.

The economy has experienced an export-led recovery but the recovery is now stalling. Fitch has revised real its 2011 GDP growth forecast to 2%, down from 3% in the previous rating review. The agency has also revised 2012 real GDP growth down to 1.8%, from 3%, reflecting its downward revision to 0.8% from 1.8% for 2012 eurozone real GDP growth.

The banking sector is well-capitalised and well-provisioned against non-performing-loans. The system proved resilient in 2010 and 2011 despite increasing tensions surrounding euro area banks. Italian and Greek banks account for 21% and 16% of total banking system assets respectively. A risk arising from any further deepening of the eurozone crisis is a reduction in funding availability for Serbian subsidiaries from their parent banks. A sharp cut in funding would impact their ability to provide credit to the economy.

In 2011 the dinar has proved more stable relative to other regional peers despite increasing stress in eurozone sovereign debt markets. National Bank of Serbia (NBS) has made fewer interventions to support the dinar in 2011 relative to 2010. A weaker growth and external financing outlook coupled with the NBS monetary easing cycle might exert downward pressure on the dinar in 2012.

Political risks weigh on the rating. In October 2011 the European Commission recommended Serbia for EU candidate status, reflecting Serbia's recent progress towards aligning political, legal and economic structures with the EU. Nevertheless the opening of formal negotiations is dependent on improvements in Serbia-Kosovo ties which remain tense.

Stronger GDP growth, a return to positive debt dynamics, and the easing of external financing risks would be positive for Serbia's creditworthiness. Over the medium-term, progress on structural reforms that facilitate EU accession would be rating positive. Conversely, persistent negative debt dynamics, or balance of payments pressures that led to a sustained fall in foreign exchange reserves, could trigger a negative rating action.

Source: Fitch Ratings.