Fitch Revises Serbia's Outlook to Negative; Affirms at 'BB-'

Fitch Ratings-London-16 August 2012: Fitch Ratings has revised the Republic of Serbia's Outlook to Negative from Stable. Fitch has also affirmed its Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BB-' and its Short-term foreign currency IDR at 'B'. The Country Ceiling has been affirmed at 'BB-'.

The Negative Outlook reflects the deterioration in the country's fiscal and external financing position and weak economic growth outlook. Rather than focusing on correcting a rising fiscal deficit and public debt ratio, the new government has amended the central bank law in a manner which has dented investor confidence and might complicate the agreement of a new IMF deal.

The new coalition government is led by the leader of the Socialist Party of Serbia, Ivica Dacic. Mr. Dacic and his party were part of the previous government, led by Mirko Cvetkovic (Democratic Party). The current coalition includes the Serbian Progressive Party (SNS), the Socialist Party-led coalition (including the Socialist Party of Serbia, United Pensioners of Serbia and United Serbia), the United Regions of Serbia, Social Democratic Party; New Serbia Party and other small coalition partners. The ruling coalition controls 144 seats out of 250 in parliament.

The first step taken by the new government has been to modify the law on the central bank. The recent legislative changes to the mechanism for appointing the governor of the National Bank of Serbia (NBS) increase Parliamentary oversight of the central bank and may reduce its independence. These changes have prompted the resignation of the governor Dejan Soskic and his deputy Bojan Markovic. A new governor, Jorgovanka Tabakovic, took office on 8 August 2012.

However, given the delay in forming a new government following the May elections, Fitch views it as a negative signal that the new government decided not to quickly address its twin deficits and rising public debt problems but rather decided to focus on changing the law on the central bank. The move was perceived by the markets as a way to limit the central bank's independence and has dented market confidence.

The delay in forming a new government after the Parliamentary and Presidential elections in May 2012 has caused a stalemate in fiscal policy. This will result in significant fiscal slippage in 2012. Fitch has revised its 2012 fiscal deficit forecast to 6.5% of GDP from 5.5% of GDP back in May 2012 and 4.3% of GDP at the time of the last review in November 2011.

Fitch's current projection assumes the adoption of some fiscal consolidation measures by the new government in September 2012. However, the new government has already ruled out any freezes on the wage and pension bill, the two biggest items on the expenditure side. Any further delay in the adoption of a supplementary budget increases the likelihood that the 2012 fiscal deficit will overshoot Fitch's projection.

The agency estimates government debt will reach 55% of GDP in 2012, well above the 45% of GDP limit set by the fiscal rule and the 'BB' median of 39%. The rule is therefore facing a test of credibility as there is no clear enforcement process in the event of a breach of the public debt threshold. Should the government not take any action to address the rise in public debt, credibility of the fiscal rule would be undermined. The government debt's foreign-currency exposure is around 82% and makes public debt dynamics sensitive to exchange rate volatility.

Fitch has also revised downwards its real GDP forecast for 2012 to negative 1% from zero growth back in May 2012. In Q212 real GDP contracted by 0.6% yoy; this was the second consecutive GDP contraction.

External finances remain a key issue for the credit rating. Although the current account deficit narrowed sharply in 2011 to 9.5% of GDP from 21% in 2008, it remains large relative to rating and regional peers. The current account adjustment has been weaker than in other emerging European markets. Fitch forecasts a current account deficit of 10.5% in 2012 due to a deteriorating trade balance combined with lower workers' remittances, repatriation of non-resident profits and higher debt service. Furthermore foreign direct investment and portfolio inflows also declined significantly in 2012, thus indicating rising external financing needs.

The recent downside pressure to the exchange rate reflects higher external financing needs but is also an indicator of weak market confidence due to the delay of the IMF's Stand-By Agreement (SBA). The NBS was forced to intervene in the foreign exchange market to cover the external financing gap and support the dinar. As a result, foreign exchange reserves declined by 12% over the first six months of 2012. On Fitch's current projection, the gross external financing requirement will stand at 61% of foreign exchange reserves in 2012, from 42% in 2010.

The new government has signalled it wishes to negotiate a new agreement, rather than restarting the original SBA. Although the IMF deal was only designed as a precautionary support, this has now changed and Fitch considers regaining access to the IMF to be important.

IMF support is likely to be needed to help finance the twin current account and fiscal deficits in 2012 and 2013. An IMF SBA might reduce the exchange rate pressures: given the high share of foreign-currency denominated debt both in the public and corporate sector, this has important implications for public debt dynamics and banking sector asset quality. It would also be an important tool in protecting the financial stability of the Serbian banking system which has a high degree of Greek parent bank ownership (approximately 15% of total assets) and therefore could be affected by events in Greece.

Political risks weigh on the rating. In March 2012 the European Commission granted Serbia candidate status, reflecting Serbia's progress towards aligning political, legal and economic structures with the EU and some improvement in Serbia-Kosovo relationship. Negotiations for EU accession remain dependent on improvements in Serbia-Kosovo ties which remain tense.

Failure by the new government to present a medium-term fiscal consolidation programme that reduces the budget deficit and stabilises the debt ratio would lead to a downgrade. Moreover balance of payments pressures that led to further falls in foreign exchange reserves could also trigger a negative rating action. Conversely, return to positive economic growth, a reduction in external imbalances and, over the medium-term, progress on structural reforms that facilitate EU accession would be rating positive.

Source: Fitch Ratings.