FITCH AFFIRMS SERBIA AT 'B+'; OUTLOOK STABLE

Fitch Ratings-London-11 July 2014: Fitch Ratings has affirmed Serbia's Long-term foreign and local currency Issuer Default Ratings (IDRs) at 'B+'. The Outlooks are Stable. The issue ratings on Serbia's senior unsecured foreign and local currency bonds have also been affirmed at 'B+'. The Country Ceiling has been affirmed at 'B+' and the Short-term foreign currency IDR at 'B'.

KEY RATING DRIVERS

The affirmation of Serbia's sovereign ratings reflects the following key rating drivers:

The newly elected government benefits from a strong mandate to implement its ambitious reform programme, having won a large majority in parliament. The May 2014 floods have caused some delays in the government's agenda, but several structural reforms affecting labour law, tax administration, land registry, bankruptcies and privatisation as well as pensions are expected to be passed in the coming months. These reforms are essential to the government's fiscal consolidation plans, as they lay the grounds for expenditure cuts and the restructuring of the state-owned enterprises (SOEs), which weigh heavily on the deficit.

Debt dynamics remain challenging, but Fitch expects some consolidation in the coming years. The consolidated general government deficit is expected to widen to 8.7% of GDP in 2014 and to fall to 5% by 2016. The government will again overshoot its initial target of 7.1% as a result of the restructuring of SOEs, further recapitalisation of state-owned banks, as well as the consequences of the May floods. The government intends to reduce current expenditure via restrictions on pensions, cuts in its wage bill and the restructuring of SOEs. Fitch expects public debt to stabilise at about 76% of GDP by 2016-17, but interest payments as a proportion of revenue will remain relatively low. One-off and off budgetary items will continue to weigh on debt dynamics in the coming years, while the issue of restitution is likely to add to the debt figures in 2015-16.

Negotiations between the Serbian authorities and the IMF to sign a precautionary lending agreement are likely to start by the end of 2014, and will greatly depend on the adoption and implementation of the government's reform and consolidation plans. Such an agreement could provide a policy anchor and would be instrumental in maintaining investor confidence.

The economic impact of the May floods is still unknown, but is likely to be manageable. GDP growth will be close to zero in 2014, while a modest pick-up is expected in 2015 because of base effects and the impact of reconstruction. Higher imports of investment goods will be partly compensated by larger donor inflows in the form of current transfers, so that the impact on the current account will be modest.

External financing pressures will continue to ease, thanks to improvements in the current account deficit and continuous inflows of foreign direct investment. The expected 10-year USD1bn

bilateral loan from the United Arab Emirates, on favourable terms, will reduce Serbia's funding costs and support its accumulation of foreign exchange reserves. Although the administration is determined to prioritise domestic issuance, exchange rate risks to government solvency remain high, as about 80% of public debt is foreign currency-denominated. Serbia's 'B+' Long-term IDRs are supported by its high income per head, superior human development and ease of doing business indicators relative to rating peers, and the recent EU decision to open accession talks with Serbia.

RATING SENSITIVITIES

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

- Credible medium term fiscal consolidation programme that reduces public debt/GDP.

- Progress on structural reforms that lead to an acceleration of economic recovery and a further narrowing of external imbalances.

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

- Failure to pass and implement structural reforms that facilitate fiscal consolidation and improve the outlook for debt dynamics.

- 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

The ratings and Outlooks are sensitive to a number of assumptions. Fitch assumes that the new government will be able to pass and implement the proposed reform agenda. Fitch assumes that the Serbian economy grows at a rate of 2% per annum over the medium term and that external finances are not subject to a severe exchange rate shock. Fitch assumes the gradual progress in deepening fiscal and financial integration at the eurozone level will continue; key economic imbalances within the currency union will be slowly unwound; and eurozone governments will tighten fiscal policy over the medium term. Fitch assumes that the US Federal Reserve exit from monetary stimulus is orderly, so that Serbia retains domestic and external market access despite higher international financial volatility.

Source: Fitch Ratings.