FITCH AFFIRMS SERBIA AT 'B+'; OUTLOOK STABLE

Fitch Ratings-London-09 January 2015: 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 government passed a series of measures in 2H14 to reduce the still large fiscal deficit. The measures included in the 2015 budget are mainly targeted at the spending side and could represent about EUR400m (about 1.5% of GDP) of savings, including a 10% cut in public salaries, a reduction in subsidies and the pension bill. The authorities also expect a reduction in the total public sector headcount and some improvement on the revenue side. The government intends to reduce the augmented general government deficit (including payments for guarantees and bank resolution costs) from about 8% of GDP in 2014 to below 6% in 2015 and below 4% by 2017.

Payment of activated guarantees to state-owned-enterprises (SOEs)have a significant impact on Serbia's deficit and were until now considered "below the line" items. These costs represented about 1.8% of GDP in 2014, and are planned to be reduced to 0.8% in 2015. The restructuring of the numerous SOEs is expected to be completed in 2015 with technical assistance from the World Bank and other international financial institutions (IFIs), although implementation risks remain. The closure of SOEs will entail redundancy payments, a large share of which has already been budgeted.

Serbia and the IMF reached a staff level agreement on a three-year precautionary agreement worth around EUR1bn in November, reflecting the government's strong fiscal intent. The IMF froze the previous stand-by arrangement in 2012 because Serbia failed to meet its fiscal and reform programme. The final approval by the IMF board is expected to take place in February, and will focus mainly on the credibility of the fiscal consolidation measures and the restructuring of the SOEs. The IMF deal will provide a policy anchor, and prior IMF approval is now required for the issuance of new guarantees to SOEs.

Debt dynamics remain challenging, with debt expected to grow to about 80% of GDP by 2016, far above the 'B' rating median of 45%. Refinancing and liquidity risks have abated slightly following the signature of the IMF programme, but financing needs remain large, at EUR5.8bn in 2015 (more than 15% of GDP). Furthermore, about 80% of public debt is foreign-currency denominated, leaving the country exposed to exchange rate shocks. However, the high level of

government deposits (about 8% of GDP) and foreign exchange reserves (about 6.5 months of import cover) could provide some buffers in the short term.

The external sector is a key weakness and vulnerability to exchange rate shocks is high. The Serbian dinar depreciated markedly in 2014, but is expected to stabilise over the forecast period thanks to the IMF deal and fiscal package as well as the large level of foreign currency reserves and the central bank's active stance to smooth short-term volatility. Dollarisation is reducing gradually, but from a high level.

The current account deficit (CAD) is projected to have remained wide in 2014, at an estimated 6.5% of GDP, partly reflecting the reconstruction efforts following the May floods, which led to an increase in imports. Automobile exports could further weaken in 2015, but the fall in domestic demand will limit import growth and bring about a gradual reduction in the CAD. The on-going deleveraging in the Serbian banking sector will only partly mitigate the increase in corporate external debt, of which a large share is inter-company lending.

The economy is expected to contract in 2015 by about 0.6%, following an estimated 2% contraction in 2014. The government's austerity measures will weigh on domestic demand, so that no significant pick-up in activity is expected in the near term. However, the potential re-launch of some manufacturing plants affected by the floods provide some upside risks for 2015. The government successfully passed several structural reforms affecting labour law, tax administration, land registry, bankruptcies, privatisation and pensions, which could support GDP growth over the medium term. The cancellation of the gas pipeline South Stream project will weigh modestly on medium-term investment plans. Serbia's 'B+' Long-term IDRs are supported by income per head above the 'B' and 'BB' median, 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 negative rating action are:

- Failure to implement fiscal consolidation that puts debt dynamics on a more sustainable path.

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

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

- Successful implementation of a credible medium-term fiscal consolidation programme that effectively reduces public debt/GDP.

- An acceleration of economic recovery and a narrowing of external imbalances.

KEY ASSUMPTIONS

The ratings and Outlooks are sensitive to a number of assumptions.

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

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.

Source: Fitch Ratings.