FITCH AFFIRMS SERBIA AT 'B+'; OUTLOOK STABLE

Fitch Ratings-London-03 July 2015: Fitch Ratings has affirmed Serbia's Long-term foreign and local currency Issuer Default Ratings (IDR) 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 is pursuing a fiscal consolidation plan. After a widening of the fiscal deficit to 6.7% of GDP in 2014, partly due to the impact of the severe May 2014 floods, we now expect the deficit to reduce to about 5% in 2015. The revision from the 6.3% forecast in January is due to encouraging data for the first few months of 2015, notably one-off items and the good performance of public revenue.

The deficit is expected to continue reducing in the coming years, to 4.4% in 2016 and 4.0% in 2017, on the back of further growth in government revenue and a reduction in subsidies to state-owned enterprises (SOEs). A reduction in pensions and the 10% cut in public salaries decided in late 2014 as part of the IMF programme is achieving results, but the government is already discussing a potential renewed increase in public wages and pensions.

As a result of the large fiscal deficit, public debt remains on a growing trend. Debt is expected to exceed 80% of GDP at end-2015, partly as a result of exchange rate effects. This number includes contingent liabilities and guaranteed debt of SOEs, worth about 9% of GDP. Debt is expected to peak at nearly 85% by 2017, well above the 'B' and 'BB' category medians. About 75% of public debt is foreign-currency denominated, exposing the debt trajectory to exchange rate fluctuations as has been the case since late 2014. However, the government maintains good access to financial markets and deposits of 8.7% of GDP at end-2014, so liquidity risks are modest.

The government is advancing the restructuring of the fiscally costly SOE sector. Despite support from international financial institutions, notably the World Bank, technical capacity constraints continue to lengthen the process. Privatisations are unlikely to generate large proceeds, but the government's primary objective is to reduce state subsidies and stop the accumulation of commercial arrears. There has been some progress with the largest SOEs, and the forthcoming 12% increase in electricity prices will help the financial sustainability of the state-owned electricity company, EPS.

The staff-level agreement with the IMF on a three-year precautionary programme signed in late 2014 has been followed successfully by the Serbian authorities so far. It has allowed for strong involvement of the IMF, as illustrated by the participation in the drafting of the 2015 budget and the necessity for it to approve the issuance of new guarantees to SOEs. The programme is proving to be an effective policy anchor and has helped reassure financial markets.

The economy contracted by 1.8% in 2014, mainly as a result of the May 2014 floods. Austerity measures will continue to weigh on domestic demand in 2015, but we expect some improvements in the external sector. The re-starting of the steel mill, which was affected by the floods, could still provide some upwards risks to our forecast.

The Serbian banking sector appears liquid and well-capitalised but the presence of four Greek-owned banks in Serbia, representing of 14.1% of total banking sector assets, could pose risks. Their legal status somewhat shields them from direct spill-overs from a potential Greek exit of the eurozone and the central bank recently applied temporary measures strengthening the monitoring of these institutions and limiting transactions with their parent banks. Although these banks have created adequate liquidity and capital buffers, reputational risks could still materialise into outflows of deposits. The costs of bailing-out one or more Greek-owned banks would be substantial and poses the risk of derailing the ongoing fiscal consolidation framework.

External vulnerabilities remain a key rating weakness. We expect the current account deficit (CAD) to continue fluctuating around 6.0%-6.5% of GDP in the coming years. Because Europe is Serbia's main trading partner, representing 65% of exports and 63% of imports, a pick-up in demand from European markets could significantly boost exports. FDI inflows appear to continue performing relatively well, covering a large share of the CAD. External debt is growing, reaching nearly 80% of GDP at end-2014, as public debt growth outweighs the modest decline in private external debt but also reflecting exchange rate effects.

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 January 2014 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:

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

- Stronger economic growth and a narrowing of external imbalances.

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

- The materialisation of contingent liabilities in the banking sector stemming from their exposure to Greece.

- 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.

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.