FITCH AFFIRMS SERBIA AT 'BB-'; OUTLOOK STABLE

Fitch Ratings-London-16 December 2016: Fitch Ratings has affirmed Serbia's Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) at 'BB-' with a Stable Outlook. The issue ratings on Serbia's senior unsecured long-term foreign and local currency bonds have also been affirmed at 'BB-'. The Short-Term Foreign Currency and Local Currency IDRs have been affirmed at 'B' and the issue ratings on Serbia's senior unsecured short-term foreign and local currency bonds have also been affirmed at 'B'. The Country Ceiling has been affirmed at 'BB-'.

KEY RATING DRIVERS

Serbia's 'BB-' IDRs reflect the following key rating drivers:

Serbia's structural features are broadly in line with 'BB' medians. GDP per capita is on par with peers, while governance indicators and ease of doing business indicators are slightly better than 'BB' medians and improving. The recent opening of EU accession negotiations and the implementation of the IMF programme support prospects for further improvement in development and governance indicators over the medium term. Fitch expects stable economic policy, reflecting the continuity in key positions in the government appointed in August 2016.

Structural reforms are advancing and could help support debt tolerance, although there have been some delays. State-owned enterprises (SoEs), which play a large role in the economy, are being restructured and streamlined, with some being privatised or declared bankrupt. Non-performing loans in the banking sector are gradually declining but remain high, at 19.2% of gross loans at October 2016. Significant capital and liquidity buffers in the banking sector mitigate financial and economic risks.

Macroeconomic performance is a rating weakness despite recent improvement. Following strong growth figures in the first three quarters of 2016 that point to a broad-based cyclical recovery, Fitch has revised its growth forecast for 2016 to 2.6% (2015: 0.7%). We expect real GDP growth to approach 3% by 2018 as investment remains dynamic and consumption is supported by rising wages.

Potential growth is lower than peers and hampered by high unemployment (15.2% at June 2016), unfavourable demographic trends, a large informal sector, and restructuring needs in the large public sector. Economic performance has historically been more volatile than peers, with volatility of real GDP growth, inflation and the real effective exchange rate all higher than 'BB' medians.

Fiscal consolidation is on track with the 2016 budget deficit expected to narrow to 2.2% of GDP (2015: 3.7%) on the back of robust revenue growth and contained spending. This will lead to an expected primary surplus for the first time since 2006. Budget outcomes have outperformed 'BB' medians since 2015. Fiscal consolidation efforts are expected to slow over the forecast horizon as the authorities approach their medium term target of a headline budget deficit of 1% of GDP.

The level and structure of public debt are key rating weaknesses. At an expected 74.6% of GDP at end-2016, public debt is much higher than the 'BB' median of 51.4%. Although Fitch expects it to decline in coming years as primary surpluses strengthen, it will remain above peers. It is also subject to dinar depreciation, as more than 75% is denominated in foreign currency (BB median: 51.3%) and annual refinancing needs are above 10% of GDP. Additionally, risks of contingent liabilities from SoEs will continue to hit public finances. Guaranteed debt is already incorporated in public debt figures, but transfers to SoEs are likely to continue as their restructuring progresses.

Serbia runs a structural current account deficit (estimated at 4% of GDP in 2016), although this has steadily declined since 2012 as FDI-related exports have strengthened. The current account deficit has been fully covered by FDI inflows since 2015, leading to a gradual decline in net external debt, which Fitch expects will reach 25.7% of GDP at end-2016 (BB median 21.2%). The dinar has stabilised against the euro (depreciating by 1.6% yoy in November 2016), helped by lower inflation. FX reserves are ample, covering more than five months of imports, and would be backed by the precautionary IMF programme in case of external pressures.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Serbia a score equivalent to a rating of 'BB' on the Long-Term FC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:
- Macro: -1 notch, to reflect weak medium term growth potential relative to peers, structural rigidities (including high unemployment, large informal economy and adverse demographics) and the large role of the public sector in the economy.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The Stable Outlook reflects Fitch's assessment that the upside and downside risks are broadly balanced.

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

- An improvement in Serbia's medium-term growth prospects,
- A material reduction in the general government debt to GDP ratio,
- A reduction in net external debt resulting from a lower current account deficit and/or higher FDI inflows.

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

- A reversal of fiscal consolidation, or the materialisation of large contingent liabilities on the government's balance sheet, that put the general government debt to GDP ratio on an upward 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

Fitch assumes that world growth will reach 2.9% in 2017 and 2018, while eurozone growth is forecast at 1.4% in both years.

Fitch assumes that EU accession talks and the IMF programme will remain important policy anchors.

Source: Fitch Ratings.