FITCH AFFIRMS SERBIA AT 'BB-'; OUTLOOK STABLE

Fitch Ratings-Paris/London-16 June 2017: 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- and Local-Currency IDRs have been affirmed at 'B'. The issue ratings on short-term 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:

Fiscal consolidation continued in 2016, with the general government deficit reaching 1.3% of GDP, a better outcome than the 4.7% deficit planned in the 2015-2017 fiscal strategy. The consolidation in 2016 was partly related to a favourable cyclical position of the Serbian economy and one-off factors, but the structural improvement in the fiscal balance is estimated at 4.5pp of GDP in 2015-2016. Spending composition has also started to improve, with the wage bill declining below 10% of GDP while public investment rose to 3.3% of GDP.

Fitch expects further fiscal consolidation, but at a much slower pace as the authorities gradually approach their medium-term deficit target of 1% of GDP. The budget was in surplus over the first four months of 2017, creating fiscal space that is likely to be used to increase wages or absorb some contingent liabilities, bringing the general government deficit to around 1.3% of GDP in 2017.

Public indebtedness remains a key rating weakness, despite the improvements seen in the government balance outturns and projections. The debt ratio declined in 2016 for the first time since 2008 to 72.7% of GDP and will likely decline below 70% of GDP by 2018. However, it is around 20pp of GDP higher than the 'BB' median and its currency structure (79.2% of total public debt was in foreign currency at end-April 2017) exposes it to dinar fluctuations. Refinancing needs exceed 10% of GDP, despite an increase in the average maturity of government debt. Fiscal risks from state-owned enterprises (SoEs) remain material, as evidenced by regular support from the budget, through subsidies, guarantee calls or debt repayment. Fitch expects this support to continue as SoE restructuring is proceeding slowly and unevenly. Risks of fiscal slippage appear contained, as an IMF Stand-By Arrangement provides a strong fiscal anchor.

Fitch considers macroeconomic performance as a weakness. Real GDP grew by 2.8% in 2016, reflecting both a favourable cyclical position and a rebalancing towards investment and net exports. The favourable employment and wage dynamics will likely support consumption growth and we expect continued FDI in the tradable sector to support export growth, therefore lifting our growth projection above 3% by 2019. However, potential growth, at around 3.5%, is hampered by unfavourable demographic trends, a large informal sector and restructuring needs in the large public sector, and is not strong enough to support income convergence with the EU. Macroeconomic stability is gradually improving, with a declining trend in inflation and improving dinarisation, but dollarisation of the economy remains high, hampering the effectiveness of the monetary policy.

External finances metrics are broadly in line with 'BB' peers. Fitch expects the current account deficit to remain around 4-5% of GDP over the forecast horizon as the expanding export base balances higher

imports and oil prices, and to be fully covered by robust FDI inflows. At 27.8% of GDP at end-2016, net external debt has been on a declining trend since 2013 and is converging towards the 'BB' median of 21.2%, which could help reduce external interest and the debt service ratio. Foreign exchange reserves cover more than five months of current account payments, ensuring a high liquidity ratio of 161.1% at end-2016. The precautionary IMF programme offers further backing in case of external pressures.

There is a large NPL overhang in the banking sector, accounting for 16.8% of gross loans at end-March 2017. NPL write-offs and sales encouraged by the central bank have helped reduce the NPL ratio in recent years, but have also contributed to moderate credit growth (+5.6% in 2016). High provisioning rates together with strong capital adequacy ratios partly mitigate financial risks, and the moderate concentration of the banking sector and its large foreign ownership component (76.7% of assets at end-2016) reduce systemic risks.

Serbia's structural features are typical of the 'BB' rating category, with GDP per capita broadly in line with the 'BB' median. Governance and business environment indicators, which are slightly better than the medians, could further improve as Serbia's institutions move towards EU standards under the EU accession negotiations. Structural reforms, particularly on state-owned companies are progressing, albeit at a slower pace than initially envisaged. Potential early legislative elections in the coming year could slow the reform process, even if Fitch expects continuity in economic policy.

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

- An improvement in Serbia's medium-term growth prospects

- Further fiscal consolidation resulting in a reduction in the general government debt to GDP ratio

- Continued reduction in net external debt

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

Source: Fitch Ratings.