FITCH UPGRADES SERBIA TO 'BB'; OUTLOOK STABLE

Fitch Ratings-London-15 December 2017: Fitch Ratings has upgraded Serbia's Long-Term Foreign-and Local Currency Issuer Default Ratings (IDRs) to 'BB' from 'BB-'. The Outlooks are Stable.

KEY RATING DRIVERS

The upgrade of Serbia's IDRs reflects the following key rating drivers and their relative weights:

High

Improving public finances are underpinned by a track record of fiscal over-performance, supported by front-loaded fiscal consolidation. Fitch expects fiscal consolidation to continue in 2018-19, leading to smaller general government deficits relative to 'BB' peers. Since 2014, an estimated 6% of GDP structural budget adjustment has been achieved, as a result of strong revenue collection and expenditure restraint on wages and pensions. Serbia has continued to outperform its budget deficit targets in 2017, with Fitch forecasting a fiscal surplus of 0.5% of GDP in 2017, the first since 2005.

Public debt sustainability is improving. After a large decline to 63.6% of GDP in 2017, Fitch expects a gradual decline in government debt to 62.1% in 2018 and 60.6% in 2019 from a peak of 74.6% in 2015. The decline is underpinned by sustained primary surpluses, positive nominal GDP growth and moderate exchange rate depreciation. However, the debt ratio is 16.6 ppts of GDP higher than the 'BB' median and its currency structure (77% of total public debt is denominated in foreign currency as of end-November 2017) exposes the sovereign to dinar fluctuations.

Medium

External finances continue to improve. At 15% of GDP, net external debt has been on a declining trend since 2013 and is converging towards the 'BB' median of 14.8%, which should help reduce external interest and the debt service ratio. Continued deleveraging by the private sector, sustained foreign direct investment (FDI) inflows, a stronger dinar and net external debt repayments by the sovereign underpin the positive external debt dynamics.

Fitch expects the current account deficit to average 4.3% of GDP (2017-2019) as the expanding export base balances higher imports and oil prices, and to be fully covered by robust net FDI inflows (5.5% of GDP). Foreign exchange reserves, estimated at USD10.9 billion in 2017, cover just below five months of current external payments. Serbia's projected liquidity ratio of 163% for 2018 is in line with the 'BB' median. Although the precautionary IMF SBA expires in February, Fitch expects continued cooperation and possibly a successor programme.

The ratings also reflect the following factors:

Fitch expects real GDP growth of 3% in 2018 and 3.3% in 2019, up from 1.9% in 2017, supported by continuing strong domestic demand, a favourable cyclical environment, and continued FDI in the tradable

sector to support export growth. Growth in 2017 was affected by adverse weather conditions which hit the agriculture sector in 1H17, together with weak energy sector performance; however, favourable underlying employment trends and wage dynamics have supported consumption in 2H17 leading into 2018.

Despite acceleration in CPI in 1Q17 as a consequence of adverse weather conditions, core inflation has remained subdued this year. Fitch expects 2017 average inflation to equal 3.2% and remain at 3% in 2018 and 2019. The National Bank of Serbia (NBS) eased its policy rate to 3.5% with two consecutive 25bps cuts in September and October, as inflation pressures remained low and inflation expectations well-anchored. Depreciation pressures have traditionally been a large component of inflation but strong FDI and portfolio investment flows, adequate FX reserves together with the NBS smoothing of dinar fluctuations should mitigate these risks.

Serbia's structural features are typical of the 'BB' rating category peers, with GDP per capita broadly in line with the 'BB' median. Governance and business environment indicators are favourable versus the 'BB' medians and could improve under EU accession negotiations. However, potential economic 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. Potential early legislative elections in the coming year could slow the reform process, even if Fitch expects continuity in economic policy.

Conditions in the banking sector remain sound. Non-performing loans (NPLs) having fallen to 11.9% in October this year from a height of 23% in mid-2015 due to write-offs and sales, encouraged by NBS. Strong capital adequacy, high provisioning rates and implementation of Basel III in June this year support the banking system and partly mitigate financial risks. The moderate concentration of the banking sector and its large foreign ownership component (76.7% of assets at end-2016) reduce systemic risks. Credit growth is forecast at 6.4% in 2017, up from 5.6% in 2016, and is supported by strong underlying growth fundamentals and progress in the resolution of troubled loans.

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 Foreign-Currency (LTFC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FCIDR by applying its QO, relative to rated peers, as follows:

- Macro: -1 notch, to reflect relatively weak medium-term growth potential due to 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 FCIDR. 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 risks to the rating are currently balanced.

However, the following factors could, individually or collectively, lead to a positive rating action:

- An improvement in Serbia's medium-term growth prospects over time without creating macro-economic imbalances;
- Sustained fiscal consolidation resulting in a reduction in the general government debt-to-GDP ratio; and
- Sustained reduction in external vulnerabilities, for instance, through a build-up of official reserves.
- The main factors that could, individually or collectively, lead to negative rating actions 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; and
- 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.