

## **Fitch Affirms Serbia at 'BB-'; Outlook Negative**

Fitch Ratings-London-26 July 2013: Fitch Ratings has affirmed Serbia's Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BB-' with Negative Outlook. The agency has also affirmed the Short-term foreign currency IDR at 'B' and the Country Ceiling at 'BB-'.

### **KEY RATING DRIVERS**

The affirmation of Serbia's sovereign ratings reflects the following factors:

- The uncertain outlook for public finances. In 2012 the fiscal deficit rose to 6.4% of GDP against the government's own target of 3.6%, partly due to pre-election spending. The government passed a supplementary budget in order to bring public finances under control. Nonetheless, Fitch expects the budget deficit to remain close to 6% of GDP in 2013 and 5% in 2014.
- Public debt is rising fast, and Fitch projects it will reach 65% of GDP by 2014. Serbia's debt dynamics are vulnerable to an exchange rate depreciation shock as 81.5% of public debt is denominated in foreign currency thereby reducing Serbia's debt tolerance.
- Fragile economic recovery; Fitch expects the current account deficit to narrow to 7.1% of GDP at end-2013 helped by stronger export performance. Real GDP contracted 1.6% in 2012 and Fitch forecasts slow growth of 2% for this year and over the medium term. Projections are however highly dependent on the automobile sector.
- The government has announced an ambitious restructuring plan regarding state-owned enterprises (SOE) and public sector entities, which is funded. However, Fitch notes that the government has yet to demonstrate the political resolve necessary to implement unpopular structural reforms, while no progress has been yet made on a comprehensive pension system reform.
- Negotiations between the Serbian authorities and the IMF to sign a Stand-By-Agreement (SBA) remain inconclusive. Fitch believes that a precautionary arrangement would promote investor confidence and guard against a reignition of global risk aversion or a material re-assessment of country specific risks.
- While the authorities operate a flexible exchange rate regime, interventions by the National Bank of Serbia (NBS) to stem depreciation pressures on the dinar have continued. As a result, official reserves at end-2012 were 8% lower yoy at USD14.4bn. NBS has gradually raised private banks' RSD reserve requirement to further contain dinar depreciation. Falling inflation in early 2013 has allowed it to end a series of interest rate hikes, cutting the policy rate to 11%.
- Serbia's rating is supported by its high income per head, superior human development and ease of doing business indicators relative to rating peers and recent EU decision to open accession talks with Serbia.

## RATING SENSITIVITIES

The Negative Outlook reflects the following risk factors that may, individually or collectively, result in a downgrade of the ratings:

- Failure to implement sufficient fiscal consolidation to put public debt on a sustainable path
- A recurrence of balance of payments pressures leading to a fall in reserves and a sharp fall in the exchange rate
- An intensification of the eurozone crisis which has a significant impact on the Serbian economy through trade and financial channels

The current rating Outlook is Negative. Consequently, Fitch's sensitivity analysis does not currently anticipate developments with a material likelihood of leading to a rating upgrade. However, future developments that may, individually or collectively, lead to a stabilisation of the Outlook include:

- Credible medium term fiscal consolidation programme that stabilises public debt/GDP
- Progress on structural reforms that lead to 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's supplementary budget passed in 2013 will promote further fiscal consolidation.

Fitch assumes that the Serbian economy grows at a rate of 2% per annum over the medium term and that the external finances are not subject to a severe exchange rate shock.

Fitch assumes that the US Federal Reserve exit from monetary stimulus is orderly but given the uncertain process it is likely to generate periodic bouts of market volatility. Fitch assumes that Serbia retains domestic and external market access despite higher international financial volatility.

Fitch assumes that there is no repetition of the policy hiatus that followed the presidential and parliamentary elections in 2012.

Source: Fitch.