

## **Fitch Downgrades Serbia to 'B+'; Outlook Stable**

Fitch Ratings-London-17 January 2014: Fitch Ratings has downgraded Serbia's Long-term foreign and local currency Issuer Default Ratings (IDRs) to 'B+' from 'BB-'. The Outlook is Stable. The issue ratings on Serbia's senior unsecured foreign and local currency bonds have also been downgraded to 'B+' from 'BB-'. The Country Ceiling has been downgraded to 'B+' from 'BB-' and the Short-term foreign currency IDR affirmed at 'B'.

### **KEY RATING DRIVERS**

The downgrade of Serbia's Long-term IDRs reflects the following key rating drivers and their relative weights:

#### **High**

Public finances continue to deteriorate. Fitch expects the consolidated general government deficit to rise for the fourth consecutive year to 7.1% of GDP in 2014 from 6.5% in 2013. The government overshot its original consolidated deficit targets in 2012 and 2013, notably as a result of the restructuring of state-owned enterprises (SOE) and the recapitalisation of state-owned banks. The government aims to reduce the central government deficit by 1.6pp of GDP in 2014 and 1.9pp of GDP in 2015. Although VAT rises and lower restrictions on public wages and pensions will contribute to this, not all savings have been identified and the plan partly relies on improving tax compliance.

Debt dynamics have continued to deteriorate due to fiscal slippage and sluggish growth. Fitch expects public debt to rise to about 70% of GDP in 2015 from the current level of 63%. This is already significantly above the 'BB' and 'B' medians and reduces fiscal manoeuvrability. Still-high contingent liabilities will continue to weigh on debt dynamics in the coming years.

#### **Medium**

Serbia's economic prospects remain relatively weak with Fitch expecting average growth slightly below 2% during the next two years. Real GDP grew 2.3% in 2013, largely driven by an increase in automotive exports and a productive agricultural season. However, because private consumption continued to contract and neither agriculture nor exports generate much tax collection, the impact on public revenue was limited. GDP growth is expected to ease in 2014 and is unlikely to be revenue-intensive, further undermining fiscal consolidation plans.

Policy credibility continues to be affected by delays in fiscal consolidation and a weak track record of structural reforms. The government's plan to restructure SOEs and public sector entities, which receive large amounts of public subsidies, is under way, but results are still uncertain. Fitch notes that the government has yet to demonstrate the political resolve necessary to implement unpopular structural reforms, although early elections could give a new government the necessary legitimacy. The timetable for a reform of labour laws has slipped from end-2013.

Serbia's 'B+' IDRs also reflect the following key rating drivers:

Serbia's 'B+' Long-term IDRs are supported by its high income per head, superior human development and ease of doing business indicators relative to rating peers, and the recent EU decision to open accession talks with Serbia.

External financing pressures have eased. A 30% rise in export earnings led to a significant reduction in the current account deficit in 2013, although at an estimated 5.2% of GDP, it remained high compared with rating peers. This allowed for an increase in foreign exchange reserves, and further modest improvements are expected in the coming years. However, Serbia is vulnerable to global financial tightening, while exchange rate risks to government solvency remain high, as about 80% of public debt is foreign currency-denominated.

Negotiations between the Serbian authorities and the IMF to sign a precautionary lending agreement could begin in 1H14. Such an agreement could provide a policy anchor and help to promote investor confidence.

New elections are expected to be held in 1H14, and are likely to be won by the Serbian Progressive Party, currently the largest party in the ruling coalition. Elections are likely to delay structural reforms, although Fitch expects that a government would be formed relatively quickly.

#### 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 a positive rating action are:

- 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 further narrowing of external imbalances.

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

- Failure to implement sufficient fiscal consolidation to put public debt on a 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 Serbian economy grows at a rate of 2% per annum over the medium term and that external finances are not subject to a severe exchange rate shock.

Fitch assumes there will be progress in deepening fiscal and financial integration at the eurozone level in line with commitments by euro area policymakers. It also assumes that the risk of fragmentation of the eurozone remains low.

Fitch assumes that the US Federal Reserve exit from monetary stimulus is orderly, so that Serbia retains domestic and external market access despite higher international financial volatility.

*Source: Fitch Ratings.*