FITCH REVISES SERBIA'S OUTLOOK TO POSITIVE; AFFIRMS AT 'B+'

Fitch Ratings-London-18 December 2015: Fitch Ratings has revised Serbia's Outlook to Positive from Stable and affirmed its Long-term foreign and local currency Issuer Default Ratings (IDR) at 'B+'. The issue ratings on Serbia's senior unsecured foreign and local currency bonds have also been affirmed at 'B+'. The Country Ceiling has been affirmed at 'B+' and the Short-term foreign currency IDR at 'B'.

KEY RATING DRIVERS

The revision of the Outlook reflects the following key rating drivers and their relative weights:

MEDIUM

The economy is slowly recovering from a recession in 2014, with Fitch revising its forecasts for 2015 and 2016 upwards. The economy is now expected to grow by 0.7% (previously 0%) in 2015 and 1.7% in 2016, driven by a pickup in investment and an recovery in mining and energy following the floods in May 2014. Consumer spending has proved resilient, supported by private sector wage growth and lower oil prices. Despite the pickup, medium-term potential growth, estimated at 3%, remains below the average five-year 'B' median growth of 4.6%.

The government is pursuing its fiscal consolidation plan. Data for the first 10 months of 2015 suggest that the budget deficit is likely to come in well below the target of 6.3% of GDP set at the start of the year. The better than expected outturn reflects strong revenue performance, boosted by one-off revenue items, as well as lower current expenditure. As a result, Fitch has revised its 2015 general government deficit forecast to 4.1% of GDP for 2015, only slightly above the 'B' median of 3.8%.

The authorities expect to run a deficit of 4% of GDP in 2016, which includes one-off expenditure items such as severance pay as well as modest wage and pension increases. Fitch believes that the 2016 budget deficit target is achievable. However, significant risks arise from the crystallisation of contingent liabilities of state-owned enterprises (SOEs), particularly those undergoing privatisation, as well as the risk posed by potential early elections.

External imbalances are improving. The current account deficit is expected to fluctuate around 4%-5% of GDP between 2015-2017, down from an average of 8.3% over the past five years. A narrowing current account deficit, combined with strong inflows of foreign investment is reducing external financing vulnerability, with the deficit fully funded by FDI in 2015. Net external debt is expected to fall to 28.4% of GDP in 2017, down from a peak of 34.1% in 2012. Foreign currency reserves represent 5.4 months of current external payments, well above the 'B' median of 3.6 months, reducing vulnerability to external shocks.

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

Large fiscal deficits have pushed debt steadily upward. Debt is estimated to rise above 75% of GDP in 2015, up from 32.6% in 2009 and well above the 'B' median of 50.4%. About 75% of public debt is foreign-currency denominated, exposing the debt trajectory to exchange rate fluctuations, as has been the case since late 2014.

The Serbian banking sector appears well-capitalised (the capital adequacy ratio is 21.4% of risk weighted assets). However, non-performing loans (NPLs) are high at 22.4% (July 2015), with 62% covered by IFRS provisions. In order to reduce legacy NPLs the government adopted an NPL resolution strategy in August 2015, aimed at identifying and addressing legal, tax, institutional and other factors that prevent debt resolution. Reducing NPLs is expected to support lending to the private sector. The Special

Diagnostic Study into 14 banks' asset quality has been completed, with the report due for publication soon. The Central Bank has indicated that it does not anticipate banks to have to raise additional capital.

The government is embarking on a reform of the public sector and SOEs, and privatising viable entities, which are key performance benchmarks under the IMF agreement. A key hurdle under the IMF programme in 2016 will be resolving 17 strategic public enterprises that have received protection from bankruptcy procedures until May 2016, although this is likely to be pushed out.

Failure to reform would add to fiscal risks and could undermine debt sustainability. Efforts to reduce the public sector wage bill are proving challenging, with plans to reduce the workforce pushed into next year. Electricity tariffs have been increased to improve the profitability of the State Electricity Company (EPC). Broader reforms are now planned for 2016.

Serbia's 'B+' Long-term IDRs are supported by income per head above the 'B' and 'BB' median, superior human development, and the January 2014 EU decision to open accession talks with Serbia. Efforts to improve the business environment have focused on making it easier to pay taxes and get construction permits and have resulted in Serbia moving up nine notches in the World Bank's 2016 Doing Business Survey, scoring well above both the 'B' and 'BB' medians. Governance is high and improving relative to peers. Measures of political stability, government effectiveness as well as regulatory quality have also improved.

RATING SENSITIVITIES

The main factors that could lead to an upgrade are:

- Successful implementation of a credible medium-term fiscal consolidation programme that effectively reduces public debt/GDP.

- Stronger economic growth and an improvement in the external position.

The current rating Outlook is Positive. Consequently, Fitch's sensitivity analysis does not currently anticipate developments with a material likelihood of leading to a downgrade. However, factors that could bring downward pressure on the ratings include:

- Failure to implement fiscal consolidation or the materialisation of large contingent liabilities on the government's balance sheet that puts debt dynamics on an unsustainable 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 government will maintain its proposed reform and fiscal consolidation agenda, in line with the IMF agreement.

Fitch assumes the gradual progress in deepening fiscal and financial integration at the eurozone level will continue; key economic imbalances within the currency union will be slowly unwound; and eurozone governments will tighten fiscal policy over the medium term.

Source: Fitch Ratings.