FITCH AFFIRMS SERBIA AT 'BB'; OUTLOOK STABLE

Fitch Ratings-London-15 June 2018: Fitch Ratings has affirmed Serbia's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BB'. The Outlook is Stable.

KEY RATING DRIVERS

Serbia's ratings are supported by strong governance, human development and ease of doing business indicators, as well as a strengthened economic policy framework, which has increased confidence that macroeconomic fundamentals have improved. The ratings are constrained by a track record of low growth, reflecting various structural bottlenecks, and high public and net external debt ratios to GDP.

Headline fiscal indicators continue to improve. A large and stable tax base, combined with contained government expenditure, will support modest fiscal surpluses in 2018-2019 averaging 0.3% of GDP. A decline in the surplus from 1.2% of GDP in 2017 reflects Serbia's fiscal strategy to increase living standards and stimulate economic growth by maintaining a low tax rate environment (which is contributing to a declining revenue-to-GDP ratio), while increasing government spending in priority areas. Measures for 2018 include an increase in the non-taxable threshold on personal earnings, increases in minimum salaries, public sector wages, pensions, as well as higher capital expenditure.

The general government debt-to-GDP ratio, at 62.5%, remains significantly above the 'BB' median of 49.0%. Progress in fiscal consolidation, leading to primary fiscal surpluses, has helped put debt on a firm downward trajectory, but fiscal risks remain. The sovereign's refinancing needs are high, with debt maturities estimated by Fitch at 9.4% of GDP in 2018 and 7.3% of GDP in 2019, above the forecast 'BB' median of 5.4% and 6.6%, respectively. Serbia's debt structure is also more exposed to FX risk than its peers; with the share of FX denominated debt to total debt at 75%, compared with a 'BB' median of 53.5%. Contingent liabilities from state-owned enterprises (4.8% of GDP) are incorporated in the general government debt number and regularly crystallise onto the budget.

Serbia is experiencing a cyclical growth recovery, boosted by stronger domestic demand and a favourable external environment. After real GDP growth of 1.9% in 2017, Serbia is projected to grow by 3.5% in 2018 and 3.3% in 2019. Five-year average growth to 2017, at 1.2%, is well below the peer median of 3.4%, reflecting strong fiscal consolidation, adverse weather-related shocks and structural weaknesses in economy. Investment, household consumption and exports, supported by positive developments in the labour market, are expected to be the main drivers of growth for 2018-2019.

Net external debt (21.9% of GDP in 2017) is above the 'BB' median (13.1% of GDP). The majority of external debt is owed by the sovereign, and by the non-bank private sector, where risks are mitigated by a large proportion of intercompany lending (around 75% of total non-bank private sector liabilities). Fitch expects a stabilisation in the net external debt ratio in 2018-2019. In both years, net inflows of FDI are projected to cover current account deficits forecast at 6.3% of GDP and 5.2% of GDP, respectively.

An improved macroeconomic environment and portfolio inflows have strengthened the RSD/EUR exchange rate. The pace of appreciation has slowed in 2018 (0.2% year-to-date vs 4.2% in 2017), but net FX purchases by the National Bank of Serbia (NBS) up to May 2018 reached EUR825 million, compared with a total of EUR725 million in 2017. The stronger dinar has helped dampen inflation. Fitch forecasts inflation in 2018 to stay within the lower band of the NBS's inflation target (3.0% +/- 1.5pp), also reflecting fading base effects from higher food prices in 2017. Inflation expectations remain well anchored at close to 3.0%, allowing the NBS to cut its key policy rate (3% as of mid-June 2018) twice this year.

Banking sector asset quality and capitalisation are improving. Non-performing loans were 8.8% in April 2018, compared with a peak of 23.2% in May 2015. The average capital adequacy ratio was 22.6% end-2017, above the median 15.3% ratio of 'BB' peers. Credit growth has picked up driven by housing and retail loans. While headline corporate lending performance is weighed down by NPL resolution, underlying growth has also gained pace. A planned restructuring of state-owned banks (SOBs), which account for 14.6% of total banking sector assets (12.2% of GDP), should further strengthen the banking sector. However, progress in addressing weaknesses in SOBs has been slow. Deposit dollarisation is high, at 68.0% at end-2017, but falling, from 69.3% at end-2016.

There is broad political consensus towards further EU integration. However, progress towards the 2025 target for membership remains constrained by delays in the implementation of institutional reform, most notably in the area of anti-corruption, and poor relations with regional neighbours. The government has expressed commitment towards anchoring gains achieved under the previous IMF SBA. While not yet finalised, a new non-financing arrangement with the IMF (through a Policy Coordination Instrument) will serve an important anchor for maintaining fiscal and macro-economic stability.

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 from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

-Macroeconomics: -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 and inefficient public sector).

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 could, individually or collectively, could lead to positive rating action are:

-An improvement in medium-term growth prospects without creating macro-economic imbalances.

-Sustained fiscal consolidation resulting in a further reduction in the government debt-to-GDP ratio.

-Sustained reduction in external vulnerabilities.

The main factors that could, individually or collectively, could lead to negative rating action are:

-A reversal of fiscal consolidation, or materialisation of large contingent liabilities on the government's balance sheet, that put 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 interest burden.

-Worsening of external imbalances, for example, from significant widening of the current account deficit leading to increased external liabilities. 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.

KEY ASSUMPTIONS

-Fitch assumes that EU accession talks will remain an important policy anchor.

Source: Fitch Ratings.