Serbia 'BB-/B' Ratings Affirmed; Outlook Positive

OVERVIEW

- Economic recovery, policy commitment, and a precautionary standby agreement with the International Monetary Fund continue to support Serbia's ambitious fiscal consolidation agenda.
- We are therefore affirming our 'BB-/B' sovereign credit ratings on Serbia.
- The positive outlook signals that we could raise our ratings on Serbia if the government overperforms on its fiscal metrics while keeping the current account deficit in check.

RATING ACTION

On June 16, 2017, S&P Global Ratings affirmed its 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on Serbia. The outlook remains positive.

RATIONALE

The ratings on Serbia are constrained by relatively low wealth levels; a high general government debt burden, most of which is denominated in foreign currency; limited monetary policy flexibility, owing to the banking sector's prevalent euroization; and the country's still-sizable stock of nonperforming loans (NPLs). At the same time, favorable economic growth potential and consistent commitment for fiscal consolidation support the ratings.

The Serbian economy is likely to expand in 2017-2019, on the back of healthy investment inflows--mainly foreign direct investment (FDI)--and stronger private sector consumption supported by expanding employment, wage growth, and a stable inflow of worker remittances. Our current assumption is that Serbia will likely see strong performance in 2017 similar to 2016 levels, despite some slowdown in growth reported in first-quarter 2017 (just 1.2% year-on-year), which likely stemmed from a one-off impact of adverse weather conditions.

That said, Serbia's long-term growth potential remains hindered by a large and only a modestly reformed public sector, poor demography, and low labor participation. In this context, structural reforms (namely to pensions, corporate governance in state-owned enterprises, public administration, and the judicial system), if implemented, could improve the country's growth potential well above our base-case forecasts, which average 2.8% between 2017 and 2020.

On a per-capita basis for the same period, we forecast Serbia's average real GDP growth to be slightly higher at about 3%. This is due to the population shrinking at an estimated 0.5% per year. Still, GDP per capita remains moderate at $5,400 in 2017. This is lower than that of Serbia's EU neighbors due to past periodic sharp depreciations of the Serbian dinar.

Economic recovery, a policy commitment to cost containment--framed by a precautionary standby agreement with the International Monetary Fund (IMF)--and one-off revenues helped the government to lower the general government deficit to 1.3% of GDP in 2016, about one-fifth of the level in 2014. This achievement underlines the government's commitment to fiscal consolidation, which we believe could in principle go even further.

A number of challenges continue to pose a risk to further fiscal adjustment, however. First, structural improvements will require deeper reforms of the public sector, including restructuring or improving corporate governance in several large state-owned enterprises (SoEs)--namely Elektroprivreda Srbije, Srbijagas, and enterprises in the mining and petrochemical industries. SoEs have been the major driver behind the past growth of government debt and still could represent significant, albeit diminished, fiscal risks. A possible second obstacle to additional fiscal adjustment is the limited visibility on whether the IMF program, which runs out in early 2018, will be followed by a new agreement. The program has so far served as a very reliable policy anchor to government fiscal efforts. Third, following recent presidential elections, the incoming primer minister's commitment to fiscal reforms will have to be tested, as the government approaches the new budget cycle and faces pressure from pre-election expenditure proposals, including those on public salary hikes.

Considering these challenges, we forecast average fiscal deficits of about 1.9% on average over 2017-2020, and a corresponding annual rise in general government debt (our preferred fiscal metric) of about 3% of GDP higher, given our expectations regarding foreign exchange movements and some modest support for public enterprises. At the same time, we still expect general government debt to gradually decline to a still high 70% of GDP by 2020.

We note a recent positive trend in terms of external imbalances. From an average of 8% of GDP in 2011-2014, we expect Serbia's current account deficit to average 4% of GDP in 2017-2020, with strong merchandise and service exports a key driver behind this improvement. We see further upside potential as a significant amount of FDI has entered the manufacturing sector, taking advantage of Serbia's lower cost structure. Looking at the current account from a savings-investment perspective, we believe the improved fiscal performance will also relieve pressure on the country's overall current account position.

In addition to declining current account deficits, we expect the composition of external financing to improve. With the opening of EU accession talks in late 2015, we expect that FDI net inflows will fully finance the current account deficits throughout our 12-month forecast horizon. Under this assumption, external debt net of public and financial sector external assets (narrow net external debt) will decline gradually to below 50% of current account receipts (CARs) in 2020 from 72% in 2015. Regarding the composition of external debt, we have observed a pronounced halt of external finance for the private sector. Unlike a few years ago, the financial sector is now in a net creditor position and net external non-financial private sector debt has reduced. These outflows were financed by rising public sector external debt, FDI, and, to a small extent, by the depletion of official reserves. We believe that this trend has now run its course, based on the stabilization of funding of the foreign banks that own most of the Serbian banking sector, as well as improved fiscal prospects. With this mix of external debt, we expect that gross external financing needs should remain roughly equal to CARs plus usable reserves.

We find Serbia's monetary flexibility limited in several respects. Foreign exchange movements have a pronounced impact on the government's debt trajectory, on inflation pass through, and on bank asset quality. Such vulnerabilities have prompted the central bank, National Bank of Serbia (NBS), to intervene in the foreign exchange market occasionally. Almost 80% of general government debt is denominated in foreign currency, principally euros and U.S. dollars.

Further, high euroization of the banking system continues to undermine the effectiveness of monetary policies, as nearly 60% of deposits and loans are denominated in foreign currency. NPLs represent another longer-term challenge. Despite a drop in NPLs to 16.8% in first-quarter 2017 from more than 21% at the end of 2015, reflecting the government's and NBS' regulatory efforts and recent NPL write-offs, their stock remains relatively high (especially in state-owned banks). Credit losses continue to weigh on banks' profitability and constrain their lending capacity. At the same time, the NBS' Special Diagnostic Studies report indicated that the banking sector remains adequately capitalized and has sufficient liquidity.

Nevertheless, NBS has proved its operational independence and earned credibility in the past few years as inflation has declined to historical lows in 2014-2016 despite high exchange rate pass-through. Rising food and energy prices will likely spur headline inflation throughout the forecast horizon, yet we expect it to stay within the NBS' target of 3±1.5%.

OUTLOOK

The positive outlook signals that we see an increasing likelihood that we would raise our rating on Serbia during the next six to 12 months if the new government's fiscal performance exceeds our expectations. Stronger export performance or further reduction in risks of sudden shifts in FDI or portfolio investments, potentially as a result of continued reform momentum, could also prompt a positive rating action. Furthermore, sustained success in keeping inflation in line with trading partners and the central bank's target could also support a rating upgrade.

We could revise the outlook back to stable if fiscal and external deficits widened compared with our forecasts, due for example to spending pressures and stalled restructuring of public enterprises; if the current account begins to widen anew; or if there are dislocations of the dinar foreign exchange market.

Source: Standard & Poor's.