Serbia Long-Term Rating Raised To 'BB' On Fiscal Overperformance; Outlook Stable; 'B' Short-Term Rating Affirmed

OVERVIEW

- Serbia's economic recovery and policy commitment, along with a precautionary standby agreement with the International Monetary Fund, have significantly improved Serbia's fiscal performance.
- We are therefore raising our long-term sovereign credit rating on Serbia to 'BB' from 'BB-' and affirming the 'B' short-term rating.
- The outlook is stable.

RATING ACTION

On Dec. 15, 2017, S&P Global Ratings raised its long-term foreign and local currency sovereign credit ratings on Serbia to 'BB' from 'BB-'. The outlook is stable. We affirmed the 'B' short-term foreign and local currency sovereign credit ratings.

At the same time, we revised our Transfer and Convertibility (T&C) assessment to 'BB+' from 'BB'.

The upgrade reflects Serbia's stronger fiscal metrics, underpinned by years of cost-containing efforts and revenue overperformance, amid steady economic recovery and contained current account deficits.

OUTLOOK

The stable outlook reflects balanced risks to the ratings over the next 12 months.

We might take a positive rating action under the combination of the following scenarios:

- If, alongside strong exports growth, we observed further reductions in Serbia's external vulnerabilities, signaled, for example, by lower external leverage or a continuing drop in risks of sudden shifts in foreign direct investment (FDI) or portfolio investments, potentially as a result of continued reform momentum;
- If government debt decreased below our current expectations; or
- If Serbia built a strong track record of keeping inflation in line with that of trading partners and the central bank's target.

Conversely, we could take a negative rating action if, contrary to our expectations, fiscal performance deteriorated, due, for example, to a stalled restructuring of public enterprises, or if balance of payments pressures re-emerge.

RATIONALE

We raised the rating because Serbia has displayed stronger fiscal metrics after years of containing costs and better revenue performance than anticipated, amid a steady economic recovery and limited current account deficits. Despite a temporary slowdown in growth in 2017, Serbia is likely to post its lowest general government deficits in almost a decade. In light of a conservative draft budget for 2018 and some progress in downsizing contingent risks coming from state-owned enterprises (SOEs), we now think that the likelihood of fiscal slippages, similar to the one that occurred in 2012-2014, has reduced. Stronger fiscal performance has put Serbia's high public debt on a downward path. The upgrade also takes into

account a sustained improvement in Serbia's external performance, which has resulted in a steady decline in external indebtedness since 2012.

The ratings on Serbia are constrained by relatively low wealth levels; a high general government debt burden, a major part of which is denominated in foreign currency; limited monetary policy flexibility, owing to the banking sector's prevalent euro-ization; and the country's declining but still-sizable stock of nonperforming loans (NPLs).

At the same time, favorable economic growth potential and the government's consistent commitment to fiscal consolidation, which has resulted in contained fiscal deficits, support the ratings.

Institutional and Economic Profile: Wealth levels are low and institutions are weak, yet we expect some policy continuity

- Investments and consumption will likely boost growth in the medium term, despite a temporary slowdown in 2017.
- The new government will likely maintain policy continuity and fiscal discipline, anchored by the EU accession process.
- The slow pace of structural reforms remains an obstacle to speeding up income convergence with the EU.

The Serbian economy is likely to have expanded in 2017 and to continue doing so in 2018-2020, on the back of healthy investment inflows-mainly FDI-and stronger private sector consumption. These have been supported by expanding employment, wage growth, and a stable inflow of worker remittances. Despite the temporary slowdown in 2017 due to the one-off impact from adverse weather conditions, our current assumption is that Serbia will see steady economic performance in the medium term.

For the same period, we forecast Serbia's per-capita average real GDP growth will be slightly higher at about 3.2%. This is due to the population shrinking at an estimated 0.5% per year. Still, GDP per capita remains moderate at $5,800 in 2017. This is lower than that of Serbia's EU neighbors due to past periodic sharp depreciations of the Serbian dinar.

That said, Serbia's long-term growth potential remains hindered by the large and only a modestly reformed public sector, poor demography, and relatively low labor participation. Moreover, the effectiveness of Serbia's public institutions remains contained by a weak judiciary, relatively high levels of perceived corruption, and low public governance standards (especially if compared with the EU average). In this context, structural reforms (namely to pensions, corporate governance in SOEs, public administration, and the judicial system), if implemented, could remove existing bottlenecks and improve the country's growth potential well above our base-case forecasts for 2.9% growth on average between 2017 and 2020.

In this context, Serbia's accession negotiations with the EU could provide a reasonable policy anchor in the medium to longer term, even though the process of EU accession might be lengthy and complex. Serbia was granted EU candidate status in 2012 and since then has opened 12 out of 35 chapters of the Acquis Communautaire, with two already temporarily closed. Meeting the conditions of some chapters will likely require difficult political decisions, though. On top of the complex but usual areas such as weaknesses in the judiciary and respect for the rule of law, Serbia will face some sensitive issues with respect to relations with Kosovo and trade agreements with Russia.

We understand that EU accession remains a goal of the new government headed by Prime Minister Ana Brnabic since June 2017. EU membership aspirations will likely constrain the ongoing centralization of power, which gathered pace ahead of the presidential elections in 2017, accompanied by the increasing

control of and restrictive actions toward independent mass media. The ruling party--the Serbian Progressive Party--currently controls both the parliament and the presidency. Although this could support the existing reform impetus and maintain the fiscal discipline pursued by the previous government and framed by a precautionary standby agreement with the IMF, weaker checks and balances between key institutions could undermine policy predictability, resulting in weaker investor confidence.

Flexibility and Performance Profile: Structural and cyclical factors support fiscal consolidation and the external position is improving, but vulnerabilities remain

- Cost-containment measures and strong revenues, including one-off nontax receipts, have supported improvements in public finances.
- Pronounced fiscal slippages are unlikely, and therefore the government's currently high debt should gradually decline, although the under-reformed public sector remains a source of fiscal risks.
- Credible inflation control will likely be maintained; yet high euro-ization continues to limit monetary policy effectiveness.

Steady economic performance will solidify the government's multiyear fiscal effort. With significant budget overperformance again this year and a 2018 draft budget implying a deficit of just 0.6% of GDP, we now think that the significant relaxation of fiscal discipline in the medium term is less likely. Our view is based on the government's track record of decisive fiscal consolidation measures implemented in 2015-2017. Despite expected moderate hikes in public-sector wages in 2018, we now forecast average fiscal deficits of about 1.5% on average over 2017-2020 compared with 2.9%-3.0% of GDP, which we expected a year ago.

Fiscal consolidation stemmed partly from strong revenues supported by economic recovery, globally low interest rates, one-off nontax revenues, and underfinancing of planned capital expenditures. However, we acknowledge that budgetary adjustments have been also supported by improved revenue mobilization and a strong policy commitment to contain costs. Under a standby agreement with the IMF, Serbia has made significant progress in keeping the public wage and pension bill under control and containing subsidies to SOEs. This resulted in an impressive expenditure-side adjustment of some 4% of GDP between 2014 and 2017. General government deficits shrank to an estimated 1% of GDP (or below) in 2017 from 6.6% of GDP in 2014.

Even though the fiscal outlook is now stronger, we still think that the relatively inefficient public sector might continue to pose some moderate fiscal risk. Large SOEs-namely Elektroprivreda Srbije, Srbijagas, and enterprises in the mining and petrochemical industries-still suffer from weak corporate governance, persistent energy arrears, and redundant employment. Despite the sale of the state-owned pharmaceutical company, Galenika, in 2017, progress in resolving these SOEs has been relatively modest. The current IMF program expires in February 2018. The new program that might replace the existing arrangement could support the required reform momentum.

Diminishing government financing needs and elevated nominal GDP growth will push down government debt in the medium term. We expect gross general government debt to continue to decline until 2020, but to remain above a still high 65% of GDP. At the same time, we note that the banking system's exposure to the public sector (the general government together with closely linked SOEs) remains elevated at slightly above 20% of total assets. This could result in private-sector borrowing being crowded out if the government's borrowing needs increase, contrary to our base-case assumptions. Almost 75% of general government debt is denominated in foreign currency, principally euros and U.S. dollars, exposing the government to exchange-rate risks. However, the recent appreciation of the dinar has been beneficial for the government's fiscal and debt metrics.

We note a recent positive trend in terms of external imbalances. From an average of 8.7% of GDP in 2011-2014, we expect Serbia's current account deficit to average 4.1% of GDP in 2017-2020, with strong merchandise and service exports as the key driver behind this improvement (in dollar terms, total exports almost doubled to about $22 billion between 2010 and 2017). 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. In line with a track record observed in 2015-2017, we expect that FDI net inflows will fully finance the current account deficits throughout the next 12 months. Under this assumption, external debt net of public and financial sector external assets (narrow net external debt) will decline gradually to below 56.3% of current account receipts in 2017 from 71% in 2015. Serbia's accumulated stock of inward FDI is relatively high (over 130% of current account receipts [CARs]). Although inward FDI generally presents much a smaller risk than external debt, it still exposes the economy to potential swings in investor confidence, resulting in balance of payments pressures.

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 nonfinancial 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 by 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 (annual payments to nonresidents) should remain slightly below 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 occasionally in the foreign exchange market to smooth the short-term exchange rate volatility. In 2017, pronounced appreciation pressures led the NBS to intervene by purchasing some €740 million (on a net basis) from January to mid-December, resulting in a hike of its usable reserves by almost 10% since January.

Furthermore, shallow local currency capital markets and high euro-ization of the banking system continue to constrain the effectiveness of monetary policies, given that nearly 60% of deposits and loans are denominated in foreign currency. Nonperforming loans (NPLs) represent another longer-term challenge. Despite a drop in NPLs to 11.9% in October 2017 from more than 21% at the end of 2015, reflecting the government's and the NBS' regulatory efforts and recent NPL write-offs, their stock remains relatively high (especially at state-owned banks). At the same time, banks' profitability is recovering and bank lending started to accelerate throughout 2017. Policy rate cuts in September and October 2017 should support this acceleration. The NBS' Special Diagnostic Studies report indicates that the banking sector remains adequately capitalized and has sufficient liquidity.

The NBS has proved its operational independence and earned credibility over the past few years. Inflation declined to historical lows in 2014-2016, despite high exchange rate pass-through. Rising food and energy prices will likely spur headline inflation through 2020, yet we expect it to stay within the NBS' target of 3±1.5%.

Source: Standard & Poor's.