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SERBIA OUTLOOK REVISED TO POSITIVE ON IMPROVING FISCAL AND EXTERNAL PROFILE; 'BB+/B' RATINGS AFFIRMED

Overview

- We project Serbia's real GDP to expand by 3.3% this year and accelerate to 3.8% on average over 2025-2027.
- Resilient economic growth should allow the Serbian authorities to improve fiscal metrics.
- Stronger external buffers alongside ample and increasingly diversified net foreign direct investment should help Serbia to mitigate possible balance of payments risks.
- We therefore revised our outlook on Serbia to positive from stable and affirmed our 'BB+/B' long- and short-term foreign and local currency sovereign credit ratings.

Rating Action

On April 5, 2024, S&P Global Ratings revised its outlook on Serbia to positive from stable. At the same time, we affirmed the 'BB+/B' long- and short-term foreign and local currency sovereign credit ratings. The transfer and convertibility assessment is 'BBB-'.

Outlook

The positive outlook reflects Serbia's strong macroeconomic outcomes in 2023 and the possible further improvements in its external and fiscal performance.

Upside scenario

We could consider an upgrade in the next 12 months should Serbia's external position improve beyond our expectations on the back of stronger exports or net foreign direct investment (FDI) inflows. Additionally, stronger fiscal performance that helps lower net government debt could also lead to an upgrade.

Downside scenario

We might revise the outlook to stable if an economic slowdown in Serbia's key EU trading partners, potential energy supply shocks, or elevated geopolitical tensions markedly weakened Serbia's growth momentum and weighed on its fiscal and balance of payments positions.

Rationale

Our ratings on Serbia are supported by the country's strong growth and FDI prospects, moderate public debt levels, and credible macroeconomic policy framework. The ratings are constrained, however, by the country's relatively weak institutional framework, comparatively low GDP per capita, a still-sizable net external liability position, and high euroization in the economy.

Institutional and economic profile: Serbia's GDP growth will accelerate in 2024 on strengthening domestic demand, and the medium-term growth prospects are solid

- The dissipating indirect effects of the Russia-Ukraine war lead us to anticipate a pick-up in Serbia's economic growth to an average 3.8% over 2024-2027.
- Despite the development of the Bulgaria-Serbia gas connector, Serbia's energy sector will continue to depend significantly on Russian gas, posing a potential vulnerability until gas supplies become more diversified.
- Serbia's journey toward EU membership will remain lengthy and complex, contingent upon the normalization of relations with Kosovo and broad adherence to EU sanctions against Russia.

Despite a challenging external environment, Serbia's exports and economic growth have remained resilient and its macroeconomic and fiscal imbalances have reduced. We anticipate real GDP to expand by 3.3% in 2024, up from 2.5% in 2023, then average 3.8% in 2025-2027. Growth will be driven by increased household consumption thanks to easing inflation, strong wage increases, and looser financial conditions. Additionally, investment will contribute positively, supported by public infrastructure projects in energy and transportation sectors. However, we expect net exports to dent growth, primarily due to higher domestic consumer demand and increased imports associated with the acceleration of Serbia's investment cycle.

Serbia has withstood past multiple shocks on the back of prudent macroeconomic management, supporting our view of the country's strong growth outlook for 2024-2027. In fact, we expect growth might accelerate should the ongoing private and public investment cycle further boost Serbia's productive capacity.

Although it's not our base-case scenario, Serbia's growth prospects could dim due to reduced external demand from key trading partners such as the EU, which receives about 65% of Serbia's exports. Additionally, Serbia's substantial reliance on Russian gas flows through the Balkan Stream Pipeline poses a risk. Nevertheless, efforts by the Serbian authorities to diversify gas import channels, such as the inauguration of the Bulgaria-Serbia gas interconnector in December 2023, will help partially mitigate this risk. As a result, Serbia will be able to import approximately 0.4 billion cubic meters of Azeri natural gas per year, out of roughly three billion cubic meters the country consumes per year.

The December 2023 snap parliamentary elections resulted in the ruling Serbian Progressive Party (SNS) coalition clinching a majority with 48% of the vote and 129 seats--a notable increase of nine seats. Concurrently, the Serbia Against Violence coalition, the primary opposition, garnered 24% of the vote and 65 seats, gaining 25 seats. Although international observers acknowledged the elections for broadly allowing freedom of expression and assembly, the process also surfaced concerns about some electoral irregularities, such as the lack of clear separation between official functions and campaign activities.

We expect a high degree of policy continuity, with the incoming government likely to advance reforms anchored by an ongoing program with the IMF. Apart from macroeconomic and fiscal targets, this IMF program focuses on structural weakness in the country's state-owned enterprises (SOEs), primarily in the energy sector. However, the ongoing centralization of the institutional framework and decision-making could undermine long-term policy predictability. This may erode investor confidence.

Serbia's EU aspirations could improve checks and balances between Serbian institutions, but the accession process will likely be lengthy and complex. Progress has been slow since the country gained EU candidate status in 2012. Only two out of the 35 chapters of the Acquis Communautaire have been provisionally closed so far, highlighting the extensive work that still lies ahead. Serbia faces hurdles common among other EU candidate countries, like improving the rule of law. But Serbia also grapples with unique challenges, notably the need to normalize relations with Kosovo and to align with EU foreign policy on Russia.

Serbia and Kosovo have made limited progress regarding the Ohrid Agreement, verbally agreed upon in March 2023. The agreement encompasses mutual recognition of documents, establishment of permanent missions, restrictions on international representation, and the formation of an ethnic Serb-dominated municipality association in Northern Kosovo. However, the formal signing of the Ohrid agreement appears unlikely in the short term amid still-heightened tensions. The strain surfaced in recent disagreements over the use of the Serbian dinar in Kosovo, primarily utilized by Serbians in Northern Kosovo, but opposed by the Kosovan government.

The EU also highlights Serbia's hesitance to align with EU sanctions against Russia as another obstacle to its accession. Serbia's dependence on Russian natural gas compounds this challenge, despite ongoing attempts to diversify its energy supply.

Flexibility and performance profile: Fiscal and external financing risks stemming from the Russia-Ukraine war have eased considerably in recent months

- The Serbian government's commitment to fiscal consolidation prompts us to anticipate a slight narrowing of the fiscal deficit to 2.1% of GDP in 2024 from 2.2% in 2023.
- We assume the current account deficit will expand to 3.9% of GDP in 2024 from 2.6%, due to high domestic demand and an increase in investment-related imports.
- FDI inflows will continue covering the current account deficit, helping to keep the central bank's foreign exchange reserves reasonably high.

We expect the Serbian government's adherence to conservative fiscal management to continue and general government deficits to remain low. Additionally, the budget aligns with targets set under the ongoing IMF Stand-By Arrangement (SBA) program.

Despite ambitious public investment targets, we think there is potential for some slight overperformance compared with the government deficit target of 2.2% of GDP in 2024. Our fiscal projections for 2024-2027 rest on our assumptions that nominal GDP growth will support revenue, allowing the authorities to accommodate increased spending toward higher public sector wages and pensions, as well as infrastructure spending. We also factor in the discontinuation of liquidity support for SOEs in the energy sector following energy tariff adjustments over the last two years. Previously, SOEs such as Srbijagas and Elektroprivreda Srbije received liquidity support to mitigate financial losses linked to the energy price shock started by the Russia-Ukraine war. This prompted the government to initiate reforms aimed at improving their profitability and governance, easing liquidity pressures in the sector. In line with previous years, the government intends to finance the deficit through a combination of international and domestic sources, including its substantial liquid cash buffers equivalent to roughly 10% of GDP.

The government remains committed to its path of fiscal consolidation, guided by a new fiscal rule due to become effective from 2025 onward. This rule aims to achieve a budget deficit of a maximum of 1.5% of GDP in 2026 and maintain public debt at or below 50% of GDP. We project that the fiscal deficit will average 1.7% of GDP over 2025-2027. Based on our projected fiscal and macroeconomic outlook, general government debt levels net of liquid assets will stabilize at around a moderate 40% of GDP in the coming two years. While Serbia's debt levels are moderate compared with those of its peers, it stands out that over 70% of the Serbian government's debt is denominated in foreign currency, exposing it to exchange rate volatility. However, the stability of the dinar and euro/U.S. dollar hedges in place help to mitigate this risk.

Increased consumer demand and higher investment-related imports lead us to anticipate a deterioration in the trade balance this year, thereby widening the current account deficit to 3.8% of GDP from 2.6% last year. We expect the current account deficit to average 4.2% of GDP between 2025-2027, but project it will be largely financed by net FDI inflows, which have played a significant role in expanding and diversifying Serbia's export base while reducing external debt in the past decade. These inflows have also bolstered the National Bank of Serbia's (NBS') foreign exchange reserves, which have increased by 17% to €27.9 billion ($30.0 billion; amounting to five months of current account payment cover) in the 12 months ended February 2024, and we expect reserves to remain broadly stable over the coming few years.

Inflation has continued to decelerate on the back of easing food, energy, and service prices; it reached 5.6% in February 2024, from 16.1% a year earlier. Similarly, core inflation has slowly been trending down, reaching 5.2% in February. Considering base effects, declining global commodity prices, a relatively stable exchange rate against the euro, and past monetary tightening, we expect both headline and core inflation to converge to the NBS' target tolerance band of 3.0% plus or minus 1.5% in the second half of 2024. In annual average terms, we project headline inflation to decline to 5.2% this year from 12.1% in 2023. Continued disinflation will likely spark the policy easing cycle in the second half of 2024.

We think financial stability risks will remain low. Serbia's banking system is well capitalized, profitable, and liquid. At end-2023, the system's Regulatory Tier 1 capital to risk-weighted assets was 19.7%, while the nonperforming loans ratio remained at a historical low of 3.2% of total assets. That said, high euroization persists, with euro-denominated deposits and loans accounting for more than 50% of total stocks. This poses challenges due to the potential vulnerability to exchange rate fluctuations, yet it remains contained by the central bank's commitment to exchange rate stability. Overall, however, the risks of contingent fiscal liabilities from the sector are contained.