Ratings On Republic of Serbia Affirmed At 'BB/B'; Outlook Stable

Overview

We view the risks arising from economic pressures in Europe as significant for Serbia, given the country's reliance on external financing, in part through eurozone ownership of over 75% of the Serbian banking sector.

Nevertheless, we expect Serbia's recently confirmed EU candidacy will encourage further foreign direct investment (FDI) into Serbia's tradeables sector, and engender a firmer commitment from the government to growth-enhancing reforms.

We are affirming our long- and short-term foreign and local currency sovereign credit ratings on Serbia at 'BB/B'.

The stable outlook balances our view of Serbia's monetary and external vulnerabilities against the country's growth potential and improving policy environment.

Rating Action

On March 16, 2012, Standard & Poor's Ratings Services affirmed its long- and short-term foreign and local currency sovereign credit ratings on the Republic of Serbia at 'BB/B'. The outlook is stable. The recovery rating is '4'. The transfer and convertibility (T&C) assessment is 'BB'.

Rationale

The ratings on Serbia are constrained by our view of vulnerabilities emanating from its high external debt, sizable current account deficits, and limited monetary flexibility due to the euroization of bank deposits and claims. The ratings are supported by Serbia's moderate government debt levels, which we expect will be slightly above 45% of GDP at end-2012 (compared to 67% in 2003), and by its EU candidate status, which boosts the potential for reforms that could stimulate growth and rebalance the economy toward a more export-driven model. We expect that the next government, following the May 6, 2012, parliamentary election, will prioritize fiscal consolidation and the ongoing key structural reforms already committed to under the 2011 Stand-By Arrangement (SBA) with the IMF.

On March 1, 2012, the EU granted Serbia official candidate status. We believe the prospect of joining the EU can give candidate countries a strong impetus for reform. That said, an official date for opening talks has yet to be set. We do not expect Serbia will join the EU until the end of the decade.

In light of our projections for weak eurozone activity, we expect that Serbia's GDP growth will average 0.5% in 2012, although there are considerable uncertainties surrounding this projection. We anticipate net exports and a gradual recovery of domestic demand will contribute to trend GDP growth returning to 4% by 2014, partly reflecting the increase in inbound FDI in Serbia's expanding tradeables sector.

After narrowing significantly during 2009, Serbia's current account deficit widened to 9% of GDP in 2011 on an increase in imports of capital equipment. The large current account deficit was primarily financed by an improvement in FDI--namely investments from Fiat and Belgian Delhaize--and substantial government borrowing (its first eurobond issuance was in September 2011). Indeed, during 2011 Serbia experienced Central and Southeastern Europe's third-highest FDI inflow as a percentage of GDP (after Montenegro and Albania), with net FDI of more than 6% of GDP. We expect Serbia's current account deficit to narrow slightly in 2012 toward 8% of GDP; we believe the impact of weakening eurozone demand on exports will be partially offset by the launch of a new (export-oriented) Fiat model. We expect the current account deficit in 2012 will be financed mainly by government borrowing (after the election)

and a drawdown of reserves. As a consequence, we project net foreign exchange reserve coverage of short-term debt by remaining maturity will decline to 90% by end-2012 from 107% in 2011.

The government's 2012 budget deficit target of 4.3% of GDP is based on what we view as its optimistic growth assumption of 1.5% (we forecast 0.5%). Because most government revenues come via indirect taxation of domestic demand (in particular VAT and excise receipts), we do not believe the government will meet its budget deficit target even if export performance remains solid, unless the authorities move forward with additional expenditure reductions. Our baseline expectation is that, after the upcoming elections, the new government will adopt what we would consider to be a more conservative supplementary budget. We note that some recent fiscal adjustments--such as the "Decentralization Law," which relocates revenues from the central government to local authorities--could, in our view, weaken fiscal accountability at the local level. This might render general government budgetary planning more challenging.

Under our baseline scenario, eurozone parent banks will rollover but not increase their lending to Serbian subsidiaries, leaving the subsidiaries to rely on domestic deposit growth to finance any credit expansion. The banking sector appears to us to be fairly well capitalized, but dependent on external financing. The euroization of bank deposits and loans remains high; while the unhedged foreign currency exposure of the corporate sector remains a risk.

Outlook

The stable outlook balances our view of Serbia's monetary and external vulnerabilities against its growth potential and improving policy environment. We could lower the ratings if, all other factors being equal, we determined Serbia's external or fiscal liabilities were increasing significantly, which might arise from widening external deficits. We could also lower the ratings if we consider external liquidity is significantly worsening, such that the rollover rate of external debt would fall below 100%. Conversely, we could raise the ratings if we consider the government has accelerated structural reforms of the public sector, the labor market, and/or the pension system. In our view such reforms would not only improve Serbia's structural fiscal position, but also mature the business environment, enabling the economy to post stronger and more consistent growth performance.

Source: Standard & Poor's.