Serbia Ratings Affirmed At 'BB-/B'; Outlook Remains Negative

Overview

We estimate that Serbia's fiscal and external deficits will gradually narrow, but we note that much-needed economic reforms face considerable hurdles.

In particular, the economy continues to be highly euroized, which limits monetary flexibility, while the net external liability position is edging toward 100% of GDP.

We are affirming our long- and short-term foreign currency rating on Serbia at 'BB-/B'.

The outlook remains negative.

Rating Action

On March 28, 2013, Standard & Poor's Ratings Services affirmed the long- and short-term foreign and local currency sovereign credit ratings on the Republic of Serbia at 'BB-/B'. The outlook remains negative. The transfer and convertibility (T&C) assessment is 'BB-'.

Rationale

The ratings on Serbia are constrained by our view of potential financing challenges in light of stubbornly high fiscal and external deficits. Limited monetary flexibility--given high euroization and a mixed track record of price stability--is also a ratings weakness. The ratings are supported by the economy's growth potential, stemming from its educated labor force and the prospect of EU membership.

In 2008-2011, the basic balance (the current account deficit excluding net FDI inflows) declined from 16% of GDP to just over 3%. However, last year it increased again to 10%. This renewed external deterioration partly reflects the sequence of FIAT's investments in Serbia's auto sector; machinery imports were booked in 2011-2012, whereas new auto exports came on line in late 2012, and are expected to pick up during 2013. We project that Serbian exports of goods and services will hit an all-time high of 45% of GDP this year, up from 31% five years ago. While the import component remains elevated, we expect Serbia's substantial merchandise trade deficit to gradually decline from an estimated 17% of GDP this year.

In contrast to 2005-2009, when foreign parent banks financed most of Serbia's high current account deficits (that is, they financed a consumption boom), in 2010-2012 the government assumed the role of external borrower. Consequently, over the last four years we estimate general government debt will have increased to 55% of GDP by end-2013 from 25% of GDP (direct general government debt not including guarantees issued on behalf of SOEs and local governments).

Over 80% of government debt is foreign-currency denominated or indexed rather than being in local currency, and is unhedged.

The government has announced ambitious plans to reduce the headline general government deficit from 6.7% of GDP to close to 3.6% this year, largely on below-inflation expenditure and revenue increases. However, we expect the depreciating currency will keep generating debt increases above the headline deficit. At the same time, we think that the government will make progress in cutting back the primary deficit to below 1% of GDP by 2015 from 4.5% in 2012, and that fiscal tightening and improved competitiveness will lower external deficits. Risks to the government's aims include Serbia's track record of increasing current expenditures above inflation ahead of elections. Although elections are not due until 2016, pressure for early elections could increase given that the most popular party, the Serbian Progressive Party (SNS), is interested in leading the coalition, which is currently led by the smaller coalition member, the Socialist Party of Serbia (SPS). More fundamental reforms to budgetary policy seem unlikely. For example, there appear to be no plans to restructure the budget to reduce the dominance of current spending (especially on public-sector personnel).

While last year's GDP contraction of 2% largely reflected negative single events--a severe regional drought and the closure of the Smederevo steel plant--other drags on growth seem to us to be chronic. For instance, since 2009 GDP has suffered from recurring declines in net parent-bank financing.

Also, we expect planned fiscal consolidation for 2013-2015 will shave off over 1% of GDP on average. As a result, we believe medium-term growth drivers will be difficult to identify unless the government is more strenuous in its reforms to the labor market and public sector. We think that Serbia's eventual EU membership could motivate governments to facilitate private-sector competitiveness—but historically the prospect of EU entry has not in all cases led to a reduction in the government intervention in the economy. In any case, the benefits of EU entry seem unlikely to materialize for several years and therefore are unlikely to reverse currently very high unemployment of about 26.0% (14.4% in 2008).

Serbia's monetary policy flexibility is constrained by high euroization. The dinar is used largely for transactional purposes, and inflation has not been in the target range of 2.5%-5.5% on an annual basis for many years.

Outlook

The negative rating outlook reflects our view of the potential for a downgrade if we see a significant deterioration in the fiscal or external positions, driven either by external shocks or domestic policy inaction.

An IMF agreement, which could provide for balance of payments support and help entrench fiscal and structural reforms, would contribute to improvements in debt stability and growth prospects, potentially leading the ratings to stabilize at the current level.

Source: Standard & Poor's.