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

Overview

- Serbia's export-led economic activity rebounded in 2013, helping narrowing external imbalances. However, the rest of the economy remains in recession, driving up the fiscal deficit and public debt, and growth drivers are limited in the near term.
- We expect that the reconstructed coalition government will begin to implement its recently announced comprehensive public sector, labor market, and pension system reforms.
- We are affirming our 'BB-/B' long- and short-term sovereign credit ratings on the Republic of Serbia.
- The outlook is negative, reflecting our view of the potential for a downgrade if fiscal pressures increase, either because of financing challenges or increasing risks to economic growth.

Rating action

On Oct. 25, 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 is negative.

Rationale

The ratings on Serbia are constrained by our view of the potential fiscal and external financing challenges that the country faces in light of its high fiscal and external deficits. The ratings are also constrained by Serbia's moderate GDP per capita and limited monetary policy flexibility, owing to the high euroization of the economy. The ratings are supported by Serbia's long-term economic growth potential, although this is obstructed by the large public sector, labor market inefficiencies, and uncertainty in the business environment.

Following the 2012 recession, economic activity rebounded in 2013 on the back of strong export growth, which has been predominantly fuelled by the automobile and agricultural sectors. Inflation returned to the central bank's target range of 2.5%-5.5% in September this year. On the other hand, domestic demand has been falling, with imports stagnating, which along with strong exports has contributed to a reduction in external imbalances.

Positively, the current account deficit narrowed significantly from over 10% of GDP in 2012 to just below 6% of GDP in 2013. That said, foreign direct investment (FDI) has contracted sharply and foreign bank lending has also contracted, albeit more modestly, leaving government borrowing as the main source of external financing. We expect net FDI inflows to remain subdued at 2% of GDP in 2013, compared to close to 6% of GDP in 2011. At the same time, the private sector is deleveraging and we expect depository corporation claims on the nongovernment sector to fall 2% this year.

We expect that economic growth will stagnate next year on the back of a further decline in consumption, burdened by high unemployment--the employment rate is 45% and the unemployment rate is over 25%--budgetary consolidation, and lower net exports. At the same time, we project investment activity to increase only marginally and remain, in real terms, well below 2007-08 peaks. We project that net FDI will rise to 3.5% of GDP, but private sector external deleveraging could push the economy again into recession.

A reconstructed coalition government took office in mid-September with the commitment to carry out ambitious short-term fiscal consolidation measures, primarily related to expenditure. The plan includes cuts to above-average public sector wages, lower subsidies to state-owned enterprises (SOEs; the government intends to wind down or privatize 179 entities in coordination with the World Bank), and an increase in the lower VAT rate from 8% to 10%. Additional measures include improving tax collection by tackling the shadow economy and improving the tax administration.

We expect these measures to reduce Serbia's persistently high headline deficits. Along with off-budget spending and a weakening currency, we estimate that the deficit will push net general government debt to 55% of GDP in 2016 from 25% of GDP in 2009. These figures do not include the nearly 9% of GDP in government-guaranteed debt that the government is increasingly servicing on behalf of loss-making SOEs. Over 80% of the general government debt is denominated in foreign currency, and over 60% of commercial debt is held by nonresidents, making the debt-to-GDP ratio very sensitive to exchange rate fluctuations. Interest expenditure has increased from less than 2% of consolidated general government revenue in 2009--we estimate that it will average over 7% in 2013-2016. The measures the government has announced so far are, in our view, unlikely to stabilize the debt-to-GDP ratio in the near term, particularly given their likely contractionary impact on economic growth, all other things being equal.

The government has also laid out a structural reform agenda, aimed at improving labor market efficiency and strengthening pension system finances. We expect the structural reform measures to boost long-term economic growth by improving the business environment reform and government effectiveness, but probably only from 2014. Possible early elections in 2014 could further complicate the timetable.

Outlook

The ratings have a negative outlook, reflecting our view that there is at least a one-in-three chance that we could downgrade Serbia in the first half of next year if:

- The government fails to implement policies that lead to the stabilization and eventual easing of the government debt burden;
- Fiscal and external financing become more costly, which would likely be a result of the government failing to secure more favorable funding; or
- Economic growth falls significantly below our current expectations for a gradual recovery.

Conversely, we could revise the outlook to stable if the government implements reforms that consolidate public finances in a sustainable way and lead to stronger economic prospects over the medium term without widening external imbalances.

Source: Standard & Poor's.