Ratings On Serbia Affirmed At 'BB-/B' On Launch Of Fiscal Consolidation; Outlook Negative

Overview

- Serbia has begun a process of fiscal consolidation, which should temper the rise in public debt over the coming year.
- We believe the 2015 budget and the tentative IMF Stand-By Agreement have assured market access in the immediate term.
- We are therefore affirming the 'BB-/B' ratings on Serbia and removing them from CreditWatch negative.
- However, we have assigned a negative outlook as uncertainties remain over the extent of medium-term fiscal reform and growth prospects remain weak.

Rating action

On Jan. 16, 2015, 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' and removed them from CreditWatch, where they were placed with negative implications on Oct. 10, 2014. The outlook is negative.

Rationale

The affirmation and removal of the CreditWatch reflect our opinion that the imminent risk of weaker sovereign creditworthiness has receded. In particular, the recent staff-level agreement with the IMF and the related passage of fiscal consolidation measures should ensure market access in the near term. Nonetheless, our ratings on Serbia are constrained by weak general government debt metrics, which are exacerbated by the high share of foreign currency borrowing. Similarly, the structural current account deficit remains high, despite narrowing substantially in recent years.

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 country's long-term economic growth potential remains supportive of the ratings.

Serbia's current political situation is more stable than most post-Yugoslavia republics. The Serbian Progressive Party (SNS) not only has a comfortable majority of 63% in parliament, it also enjoys widespread popular support and has a coalition partner supporting a broader consensus. This should help increase public acceptance of difficult and politically sensitive reforms and austerity measures. Yet, progress on domestic legislation so far has been mixed while EU accession is noticeably slower than expected.

The delay of major policy initiatives was partially due to severe flooding in May 2014. That said, we note the recent passage of laws regarding the restructuring of state-owned enterprises (SOEs). The sell-off or dissolution of 502 non-strategic SOEs will free up assets for better economic use by private-sector actors, and reduce indirect burdens on the state. But, the medium-term financial fate of the larger public enterprises, for example, natural gas provider Srbijagas, is critical. Together with expected public administration reforms, this could reduce the distortive use of resources across the economy and promote competitive businesses that could, in turn, generate sustainable employment. Serbia's challenges are comparable to other post-Communist Central and Eastern European states. The difference is that Serbia now faces a weaker global economy and has a dual legacy as a state and federal center.

The government's main immediate challenge is fiscal consolidation. The government signed a three-year staff-level IMF agreement in November 2014, providing a €1 billion precautionary line and acting as a policy anchor. While austerity measures enacted in late 2014 and in the 2015 budget cycle are helpful, it is too early to ascertain whether they will suffice to stabilize the public debt trajectory. In this regard, we are awaiting further details on medium-term fiscal plans as well as the exact nature of the IMF agreement. Assuming current expenditure savings will be locked in and future budgetary support to public enterprises will be reduced, we calculate the average annual change in government debt to average 5.7% of GDP in 2015-2018, only slightly higher than our projection for the average general government deficit of 4.8%. This would be just enough to stabilize public debt levels if economic growth returned to over 2% and inflation rose to above 4.5% from 2017 onward, as we currently expect.

Nonetheless, key questions remain, notably with regard to reform of public enterprises and the size and efficiency of the public sector. Since the government began to service large chunks of its guaranteed debt portfolio, we now consider most of that debt burden equivalent to general government debt. As a result, net general government debt (gross debt minus liquid assets) has soared to above 60% of GDP from just 25% in 2009. Consequently, general government interest payments as a share of general government revenues have jumped to nearly 9% in 2015 from less than 2% in 2009. Again, any debt stabilization would foresee these levels being maintained after consolidation is completed in 2017.

By then, some of the recent structural reforms (e.g. labor, pension, corporate bankruptcy, and privatization laws) should have helped revive growth. In the meantime, the recession will continue, particularly in the wake of the cancellation of the South Stream gas pipeline. We estimate Serbia's economy will contract by 0.5% in real terms this year, but grow again by 1.3% in 2016 before accelerating to a modest average of 2.2% per year, thereafter. In per capita terms, this equates to an average of 1.8% growth over 2015-2018, although this figure is flattered by the population shrinking at an estimated 0.5% per year. This translates into GDP per capita of below $6,000, lower than any EU neighbors and Montenegro.

Low wealth levels also indicate Serbia's untapped growth potential, particularly in the development of new export facilities. The growth in automotive production shows that foreign investment can be channeled into transforming industrial assets formerly belonging to the state and leveraging Serbia's lower cost structures to build competitive industries. As an EU accession country, Serbia's expected public and private investment inflows could be channeled into exports, in particular. Together with compressed import demand due to the weak economy, we believe the current account deficit will remain roughly unchanged, averaging 6.2% of GDP in 2015-2018.

We assume that foreign direct investment (FDI) inflows should finance at least half of Serbia's annual current account deficit. This should limit the need to raise large external debts. However, given the already high gross external debt stock (93% of GDP in 2015), external financing remains a key vulnerability to Serbia's creditworthiness. Gross external financing needs should remain roughly equal to 105% of current account receipts (CARs) plus usable reserves. In dollar terms, we estimate Serbia's 2015 gross external financing requirement (current account deficit plus long-term debt amortization plus short-term debt maturing) at $11.7 billion. We project that 85% ($6.1 billion) of the current portion of long-term external debt will be refinanced at similar maturities, all short-term external debt ($1.9 billion) will be rolled over, and FDI will remain at 2013-2014 levels ($1.5 billion). We forecast that the public sector will raise the remaining requirement ($2.2 billion); half through official borrowing and half via Eurobond issuance, portfolio flows to the domestic government bond market, and, if needed, a drawdown of external fiscal assets.

Another external vulnerability is that 79% of general government debt is denominated in foreign currency, and about 60% of commercial debt is held by nonresidents. This makes the fiscal debt-to-GDP ratio sensitive to exchange-rate fluctuations. Such fluctuations have prompted the National Bank of Serbia to pursue a more restrictive monetary policy than its inflation targeting would suggest. As a floating currency, the dinar provides a flexible adjustment mechanism. Recent inflation at the lower end of the central bank's target range (2.5%-5.5%) should not detract from Serbia's history of exceeding its inflation targets.

Outlook

The negative outlook reflects our view that there is at least a one-in-three chance that we could lower the ratings within the next 12 months if:

- There is any further deterioration to the government's debt profile, particularly if it results in the interest burden rising further;
- Economic growth underperforms our expectations;
- External financing becomes more costly, either because bank rollover rates fall below our expectations or because the public sector's access to markets weakens; or
- The central bank adopts a more interventionist foreign exchange policy.

We could revise the outlook to stable if medium-term reforms consolidate public finances in a more sustainable way, leading to stronger economic prospects over the medium term without widening external imbalances.

Source: Standard & Poor's.