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

OVERVIEW

- Serbia has embarked on an ambitious fiscal consolidation and reform path.
- We are therefore affirming our 'BB-/B' ratings on Serbia.
- The negative outlook reflects our belief that downside risks persist, due to the country's still-high external financing needs and dependence on foreign savings.

RATING ACTION

On July 17, 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'. The outlook remains negative.

RATIONALE

The ratings on Serbia remain constrained by weak general government debt metrics, which are exacerbated by its high share of foreign currency borrowing. Similarly, despite narrowing substantially in recent years, the current account deficit remains wide, translating into still-high external financing requirements. The ratings are also constrained by Serbia's moderate GDP per capita and limited monetary policy flexibility, owing to the high euro-ization of the economy. The country's long-term economic growth potential remains supportive of the ratings.

Serbia's government, led by Prime Minister Aleksandar Vučić of the Serbian Progressive Party, has embarked on a path of fiscal consolidation that is well anchored by a three-year €1.2 billion standby agreement (SBA) from the International Monetary Fund (IMF), which the authorities want to treat as precautionary. The government has cut public sector wages and pensions, increased electricity tariffs by 12.2%, and removed protection from creditor claims for several state-owned enterprises (SOEs). In addition, the government decided to restructure, sell, or liquidate more than 500 SOEs. In the medium term, we believe these steps will put public finances on a more sustainable path and reduce the state's role in the economy. At the same time, we believe no fiscal reform will bring lasting success without some reform of the largest SOEs, such as the electricity provider Elektroprivreda Srbije, Srbijagas, and Serbian Railways.

In our view, the IMF SBA will help anchor policy, even though the government does not intend to draw on it. Successful completion of the individual reviews will help maintain confidence, particularly of international investors. Public support for the government and its fiscal measures remains broad, and our rating affirmation is based on our expectation that the government will not deviate significantly from its consolidation path prior to the upcoming local elections in spring 2016.

We believe the government's reform efforts will narrow the general government deficit over time. In 2014, the deficit widened to 6.6% of GDP, given that this is when the government started servicing a number of guarantees for SOEs. In 2015, we forecast the deficit will start declining toward 3.9% of GDP in 2018 as revenues improve due to higher tax collection and reduced expenditures on the back of the government's consolidation measures. At the same time, we believe general government debt will peak at

75% of GDP in 2016, since we expect that the government will continue to have more activated guarantees to service.

After contracting 1.8% in 2014 mainly due to floods, the economy will experience flat growth in 2015, according to our projections. While investment activity and industrial production are likely to accelerate, we believe fiscal consolidation will depress private and public consumption. There is, however, upside potential to our forecast this year if, for instance, the Železara Smederevo steel mill increases production significantly.

That said, structural reforms (namely to labor, pension, corporate bankruptcy, and privatization laws), if implemented, have the potential to revive growth further. This underpins our expectation of average medium-term economic growth of 1.9% between 2016-2018. While Serbia's average per-capita growth over this period is slightly higher at 2.4% due to the population shrinking at an estimated 0.5% per year, GDP per capita remains less than $6,000 in 2015, lower than any EU neighbors.

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. With a chance of opening the first EU accession later this year, Serbia's expected public and private investment inflows could be channeled into its export sector, in particular. We believe export growth will mitigate the modest acceleration in import demand and that the current account deficit will gradually decline to about 4.9% of GDP in 2018 from about 5.4% of GDP in 2015.

We assume that foreign direct investment (FDI) inflows will continue to finance more than half of Serbia's annual current account deficit. This should limit the need to raise large new external debts. However, given the already high gross external debt stock (82% of GDP in 2014), external financing remains a key vulnerability to Serbia's creditworthiness. Gross external financing needs should remain roughly equal to current account receipts (CARs) plus usable reserves. We expect narrow net external debt (gross external debt net of financial sector assets and reserves) will decline gradually to 71% of CARs in 2018 from 81% in 2015.

In U.S. 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 $9.9 billion. We project that 78% ($5 billion) of the current portion of long-term external debt will be refinanced at similar maturities, all short-term external debt ($1.5 billion) will be rolled over, and FDI will remain at 2013-2014 levels ($1.4 billion). We forecast that the public sector will raise the remaining requirement ($2 billion) through 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 while more than 60% of commercial debt is held by nonresidents. This makes Serbia much more vulnerable to changes in foreign investor sentiment and the debt-to-GDP ratio more sensitive to exchange-rate fluctuations.

Such fluctuations have prompted the National Bank of Serbia (NBS, the central bank) to pursue a more interventionist monetary policy than its inflation targeting would suggest. Inflation has exceeded the NBS's target range (currently at 2.5%-5.5%) several times over the past 10 years. Recent undershooting of the inflation target is a result of lower imported inflation, particularly in oil and food, and the absence of regulated price increases.

The presence of Greek subsidiaries in Serbia (accounting for 15% of banking sector assets in 2015) may pose some risk for financial sector stability. While these subsidiaries report strong capital buffers and are tightly supervised by the NBS, weakening confidence from the situation in Greece may increase pressure on their deposits. We expect systemwide deposits, however, to remain stable, with other domestic banks gaining market share from the Greek subsidiaries.

OUTLOOK

The negative outlook reflects our view of risks to the ratings over the next 6-12 months from Serbia's still-large external financing requirements and the country's dependence on foreign savings. In addition, there is still a risk of a slowdown in reform momentum and fiscal consolidation with local elections scheduled for spring 2016.

We could lower the ratings if the government waivers in implementing its policies by, for example, postponing the restructuring of the SOE sector or by running higher fiscal deficits. We could also consider lowering the ratings if we saw conditions deteriorating for Serbia meeting its external financing requirements.

At the same time, we could revise the outlook to stable if fiscal consolidation leads to faster-than-anticipated reductions in fiscal deficits and thus the government debt burden or if the government improves the savings-to-investment balance more than we expect.

Source: Standard & Poor's.