Outlook On Serbia Revised To Stable On Commitment To Reform; 'BB-/B' Ratings Affirmed

OVERVIEW

- Serbia has completed the third review under the International Monetary Fund's standby agreement, amid an investment-led economic recovery.
- Serbia's current account deficit has narrowed, and we expect it will have been fully covered by foreign direct investment in 2015.
- We are revising our outlook on Serbia to stable from negative and affirming our 'BB-/B' ratings.
- The stable outlook reflects our view that Serbia's improving economic outlook balances risks associated with its large external financing needs, high general government debt, and limited monetary policy flexibility.

RATING ACTION

On Jan. 15, 2016, Standard & Poor's Ratings Services revised its outlook on the Republic of Serbia to stable from negative. The 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on Serbia were affirmed.

RATIONALE

The outlook revision reflects our view that risks to Serbia's ambitious fiscal consolidation and structural reform program have subsided somewhat. Amid signs of modest growth, fueled by investments, the government continues to tackle structural issues in the economy and public sector. We expect these developments to foster investor confidence and support Serbia's still-significant external financing needs.

The ratings on Serbia remain constrained by mounting general government debt, which could be exacerbated by a high share of foreign currency borrowing should the dinar depreciate. Further constraints include Serbia's moderate GDP per capita, large amount of problem assets in the banking sector, and limited monetary policy flexibility, owing to the high euroization in the banking system. The country's long-term economic growth potential, particularly if supported by continued structural reform, supports 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 from the International Monetary Fund (IMF), which the authorities want to treat as a precautionary measure. 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 has 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. During 2015, significant steps were taken to restructure the largest SOEs, such as the electricity provider Elektroprivreda Srbije, Srbijagas, Serbian Railways, and Roads and Corridors of Serbia, including reduction of employees, tariff increases, separation of various functions, and cost savings. However, there has been little success in privatizing SOEs, as shown by the failed attempt to sell TeleKom Serbia. This demonstrates the challenges for these companies, and we expect a large proportion of non-strategic SOEs to enter into bankruptcy.

In our view, the IMF's standby agreement will help anchor policy, even though the government does not intend to draw on it. Successful completion of the IMF's reviews will help maintain confidence in Serbia, particularly of international investors. Public support for the government and its fiscal measures remains broad, and the government has not deviated significantly from its consolidation path in the 2016 budget, ahead of local elections this year. Key budget measures include reducing subsidies for two public broadcasting companies, limiting agriculture subsidies, a modest 1.25% increase in pensions, continued reduction of public-sector employees, and a targeted increase of public employees in selected areas, financed by higher excise taxes.

We believe the government's reform efforts, if they continue, will narrow the general government deficit over time. In 2015, we estimate the general government deficit will have narrowed to 4.1% of GDP, with a onetime boost from non-tax revenue, mainly retroactive dividends from SOEs. We expect the general government deficit to remain at a similar level in 2016, taking into account onetime costs related to severance and pension payments for public-sector employees. In addition to the 9,000 headcount reduction at the beginning of this year, the government has committed to reducing the number of public employees by a further 20,000 during 2016.

Fiscal performance has been weak since 2009, with general government deficits averaging 5.5% of GDP between 2009 and 2014. Moreover, the headline deficit masks Serbia's even weaker fiscal situation, since general government debt almost doubled (up by 9.7% of GDP on average) in the same period, due to additional liabilities transferred to the government's balance sheet from SOEs. We expect the two ratios to be closer together in the future as SOEs are restructured and hidden costs are brought onto the government's balance sheet. The government has said it will not provide further aid to the SOEs during the restructuring process. We expect general government debt to peak at 78% of GDP in 2016, taking into account further calls on state guarantees.

After contracting by 1.8% in 2014, mainly due to floods, the Serbian economy will have shown modest growth in 2015. The key driver for the recovery is investment inflows, mainly from foreign direct investment (FDI). Net exports, although having increased, contributed less to growth, mainly due to the import of equipment and other investment goods. The two largest exporters, Fiat and Železara Smederevo steel mill, both increased production in 2015. While we expect investment activity and industrial production to accelerate, fiscal consolidation will depress private and public consumption.

That said, structural reforms (namely to labor, pension, corporate bankruptcy, and privatization laws), if implemented, could stimulate growth further. This underpins our expectation of average medium-term economic growth of 2.1% between 2016 and 2018. Although we forecast Serbia's average per capita growth over this period to be slightly higher at about 2.7%, due to the population shrinking at an estimated 0.5% per year, GDP per capita declined to $5,300 in 2015, lower than that of Serbia's EU neighbors, due to the dinar's depreciation against the dollar. We expect GDP per capita to recover to close to $6,200 by 2018 if modest economic growth continues. Lower wealth and income levels also indicate Serbia's untapped growth potential, particularly in the development of new export facilities. The expansion in auto production shows that foreign investment can be channeled into transforming former state industrial assets and leveraging Serbia's lower cost structures to build competitive industries.

In 2015, export growth and higher remittances helped narrow the current account deficit. We estimate the deficit at about 4% of GDP for the year and expect that FDI will have financed the gap, in view of the 35% year-on-year increase in FDI in the first 10 months of 2015. With the opening of two chapters of EU accession in late 2015, we expect that FDI inflows will continue. We believe FDI financing to the current account is more sustainable and stable. However, given still-high gross external debt (estimated at 84% of GDP in 2015), external financing remains a constraint 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 about 63% of CARs in 2018 from 69% in 2015.

Another external vulnerability is that 79% of general government debt is denominated in foreign currency. This makes Serbia's debt-to-GDP ratio more sensitive to exchange-rate fluctuations.

Such fluctuations have prompted the central bank, National Bank of Serbia (NBS), to pursue a more interventionist monetary policy than its inflation targeting would suggest. Inflation has exceeded the NBS' target range of 2.5%-5.5% several times over the past 10 years. More recently, lower imported inflation, particularly regarding oil and food, and the absence of regulated price increases have led to lower inflation rates than targeted.

The NBS' Special Diagnostic Studies (SDS) report indicates that the banking sector remains adequately capitalized and has sufficient liquidity. Nonperforming loans (NPLs) accounted for 22% of total loans at the end of September 2015, but could be higher according to the SDS report. Corporate NPLs have been declining as the manufacturing sector recovers, while household NPLs continue to climb. Despite the central bank's accommodative monetary policy, credit losses continue to weaken banks' profitability and limit lending to the recovering economy.

OUTLOOK

The stable outlook reflects our view that potential upside from Serbia's stronger economic growth outlook and better fiscal performance, if fiscal and structural reforms are implemented, balance risks associated with still-significant external financing needs, high general government debt, and limited monetary policy flexibility.

We could raise the ratings if the government perseveres with fiscal consolidation and implements structure reforms, builds a track record of effective economic and fiscal management, and continues Serbia's economic and institutional integration with the EU.

We could lower the ratings if the reform momentum falters, as shown for example by delays to restructuring the SOE sector or rising fiscal deficits. We could also consider lowering the ratings if we saw deterioration of the conditions necessary for Serbia to meet its external financing needs.

Source: Standard & Poor's.