Serbia 'BB-/B' Ratings Affirmed; Outlook Stable

OVERVIEW

- We expect Serbia to remain on track for coming reviews under the International Monetary Fund's standby agreement, amid an investment-led economic recovery and expected policy continuity.
- We anticipate renewed momentum for structural reform under the newly elected government, over the next six to 12 months.
- We are therefore affirming our 'BB-/B' sovereign credit ratings on Serbia.
- 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 July 1, 2016, S&P Global Ratings affirmed its 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on Serbia. The outlook is stable.

RATIONALE

The affirmation reflects our view that the incoming government will continue to implement Serbia's ambitious fiscal consolidation and structural reform program. Amid signs of modest growth recovery, supported 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 authorities have 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. During 2015, the government cut public-sector wages and pensions, increased electricity tariffs by 12.2%, and removed protection from creditor claims for several state-owned enterprises (SOEs).

We expect the tariff increases and further restructuring of 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. However, there has been little success in privatizing SOEs, as shown by the failed attempt to sell Telekom Srbija in 2015. This demonstrates the challenges for these companies, and we expect a large proportion of non-strategic SOEs to enter into bankruptcy. During 2015, significant steps were taken to restructure the larger public enterprises, 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. We expect the restructuring of these companies to continue after the new government is formed.

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 2016 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 2016, we expect the general government deficit will narrow to 3.2% of GDP, absent further support to public companies or SOEs, as one-off costs related to budgeted severance and pension payments for public-sector employees are unlikely to materialize. We expect the general government deficit to remain at around 3% of GDP in 2017-2019. In addition to the 9,000 headcount reduction in early 2016, mainly by not replacing retiring personnel, the government has committed to cutting the public service by a further 20,000 this year, but we do not believe the target would be achieved.

Fiscal performance has been weak since 2009, with general government deficits averaging 5.5% of GDP between 2009 and 2014. The headline deficit masks Serbia's even weaker fiscal situation, since general government debt almost doubled (up by 9.7% of GDP on average per year) in the same period, due to additional liabilities transferred to the government's balance sheet from SOEs and public companies. We expect the two ratios to draw closer together in the future as SOEs are restructured and hidden costs are brought onto the government's balance sheet. As a result, we expect general government debt to peak at 78.5% of GDP in 2017, taking into account further calls on state guarantees.

The Serbian economy saw a modest recovery of 0.7% in 2015, driven by investment inflows--mainly 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 2.5% between 2016 and 2019. Although we forecast Serbia's average GDP per capita growth over this period to be slightly higher at about 2.8%, due to the population shrinking at an estimated 0.5% per year, GDP per capita declined to $5,100 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 $6,100 by 2019 if modest economic growth continues. Besides the lack of growth-oriented economic policies in the past, 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 from an average of 8.3% of GDP in 2011-2014 to 4.8% in 2015. Moreover, the gap was more than covered by net FDI inflows amounting to 5.5% of GDP. With the opening of two chapters of EU accession talks in late 2015, we expect that FDI inflows will continue to finance the current account deficits. We believe FDI financing to the current account poses less external liquidity risk. However, given still-high gross external debt (estimated at 3% of GDP in 2016), 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 below 60% of CARs in 2019 from 73% in 2015, should net FDI inflows remain robust.

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 related to 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 20% of total loans at the end of March 2016, according to NBS. Corporate NPLs have been declining as the manufacturing sector recovers, while household NPLs also dropped slightly in recent quarters. Despite the central bank's accommodative monetary policy, credit losses continue to weigh on banks' profitability and constrain lending to the recovering economy.

OUTLOOK

The stable outlook reflects our view that, in the next 12 months, we do not expect the rating on Serbia to change from the current level, as the potential for fiscal consolidation is balanced against downside risks associated with Serbia's already high debt burden and external financing risks.

We could raise the ratings if the government perseveres with fiscal consolidation, including by downsizing the public sector and reducing state involvement in the economy, leading to narrowing budget deficits, including off-budget expenditures to below 2% of GDP and sustained reduction in net general government debt burden. In the longer term, creditworthiness could improve if the government 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 and debt. We could also consider lowering the ratings if we saw a reversal of the recently improved external indicators.

Source: Standard & Poor's.