Serbia Outlook Revised To Positive On Stronger Prospects For Fiscal Consolidation; 'BB-/B' Ratings Affirmed

OVERVIEW

- The Serbian government's 2016 fiscal outturn exceeded our expectations. We believe the government will continue to consolidate public finances under the aegis of its precautionary IMF standby agreement.
- We have modestly raised our 2017 growth forecast for Serbia thanks to continued strong investment.
- We are therefore revising our outlook on Serbia to positive from stable and affirming our 'BB-/B' sovereign credit ratings.
- The positive outlook signals that we could raise our ratings on Serbia if the government overperforms on its fiscal metrics while keeping the current account deficit in check.

RATING ACTION

On Dec. 16, 2016, S&P Global Ratings revised its outlook on Serbia to positive from stable. At the same time, we affirmed our 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on Serbia.

RATIONALE

The outlook revision reflects Serbia's improved fiscal performance and the prospects for further gains. The rating affirmation reflects the longer-term features of Serbia's credit profile. These include a high general government debt burden, most of which is denominated in foreign currency; a GDP per capita of just above $5,000; limited monetary policy flexibility, owing to the banking sector's prevalent euroization and its high stock of nonperforming loans; and favorable economic growth potential, in part due to the Progressive/Socialist party coalition's structural reform agenda.

We project that Serbia's general government will end 2016 with a fiscal deficit at 2.2% of GDP, versus our previous forecast of 3.2% of GDP. The improved result stems from buoyant revenues from VAT and excise taxes, higher non-tax revenues, and one-off revenue coming from the sale of the 4G spectrum rights. The government's three-year €1.2 billion precautionary standby agreement with the IMF helped frame the fiscal stance. We believe that government's efforts to contain costs and mobilize revenues will result in general government deficits stabilizing at 3% of GDP, on average, in 2017-2019 compared with 5% in 2011-2016. These projections are slightly weaker than those of the government as we anticipate spending pressure coming from public wages and pensions. Deficits of this range imply an annual rise in general government debt (our preferred fiscal metric) of about 1% of GDP higher, given our expectations regarding foreign exchange movements and some modest support for public enterprises.

The broader public sector has been a perennial weak point in Serbia's credit profile. During 2015 and 2016, the government took steps to restructure the larger public enterprises, such as Elektroprivreda Srbije, Srbijagas and Serbian Railways, including through the reduction of employees, separation of various functions, and cost savings. Provided these efforts continue, we expect general government debt

to peak at 75% of GDP by year-end 2016 followed by a decline in 2017-2019. This forecast takes into account only modest calls on state guarantees but is highly vulnerable to foreign exchange movements, as only 20% of general government debt is denominated in Serbian dinar.

The Serbian economy saw a continued recovery throughout 2016, with real GDP expected to grow by 2.7%, driven by investment inflows--mainly foreign direct investment (FDI). While we expect investment activity and industrial production to accelerate, fiscal consolidation might weigh on private and public consumption. That said, structural reforms (namely to labor, pension, corporate bankruptcy, and privatization laws), if implemented, could stimulate growth beyond our forecasts, which are just over 2.5% between 2017 and 2019. Although we forecast Serbia's average GDP per capita growth over this period to be slightly higher at about 3%, due to the population shrinking at an estimated 0.5% per year, GDP per capita remains at moderate $5,200 in 2016. This is lower than that of Serbia's EU neighbors due to past periodic and sharp depreciations of the dinar. We expect GDP per capita to recover to close to $6,200 by 2019 if modest economic growth continues and the current account deficit remains in check.

In this regard, we also note a positive trend. From an average of 8% of GDP in 2011-2014, we expect Serbia's current account deficit to fall below 4% of GDP in 2016 and average 3% of GDP in 2017-2019. Stronger merchandise exports have led the improvement to date. We see further upside potential as a significant amount of FDI has entered the manufacturing sector, taking advantage of Serbia's lower cost structure. Worker remittances have also been robust. Looking at the current account from a savings-investment perspective, we believe the improved fiscal performance will also relieve pressure on the country's overall current account position.

In addition to declining current account deficits, we expect the composition of external financing to improve. With the opening of EU accession talks in late 2015, we expect that FDI net inflows will fully finance the current account deficits throughout the 12-month forecast horizon. Under this assumption, external debt net of public and financial sector external assets will decline gradually to below 60% of current account receipts (CARs) in 2019 from 70% in 2016. Regarding the composition of external debt, we have observed a significant sudden stop of external finance for the private sector. Net external debt of the financial sector, for example, declined from 31% of CARs in 2009 to near balance this year and gross non-financial private sector debt fell by slightly less. These outflows were financed by rising public sector external debt, FDI, and, to a small extent, by the depletion of official reserves. We believe that this trend has now run its course based on the stabilization of funding of the foreign banks that own most of the Serbian banking sector, and improved fiscal prospects. With this mix of external debt, we expect gross external financing needs should remain roughly equal to CARs plus usable reserves.

We find Serbia's monetary flexibility limited in several respects. Foreign exchange movements have a big impact on the government's debt trajectory, on inflation pass through, and on bank asset quality. Such vulnerabilities have prompted the central bank, National Bank of Serbia (NBS), to intervene in the foreign exchange market occasionally. Almost 80% of general government debt is denominated in foreign currency, principally euros and U.S. dollars. Inflation has exceeded the NBS' target of 4%±1.5 percentage points several times over the past 10 years. We note, however, that inflation declined and stabilized in 2014-2016 due to domestic factors; lower imported inflation, particularly related to oil and food; and only moderate regulated price increases. Nearly three quarters of deposits and loans were denominated in foreign currency at the end of the second quarter of 2016. The NBS' Special Diagnostic Studies report indicates that the banking sector remains adequately capitalized and has sufficient liquidity. However, nonperforming loans (NPLs) accounted for a still high 19.2% of total loans at the end of October 2016, according to NBS. Corporate NPLs have been declining as the manufacturing and construction sectors recover, while household NPLs also dropped slightly in recent quarters. Nevertheless, credit losses continue to weigh on banks' profitability and constrain lending to the recovering economy.

OUTLOOK

The positive outlook signals that we see at least a one-in-three chance that we would raise our rating on Serbia during the next 12 months if the government's fiscal performance exceeds our expectations and the country's current account deficit remains in check. Key metrics, which would signal such a scenario, would include a reduction in the change in general government debt as a share of GDP and Serbia's gross external financing needs as a share of CARs plus usable reserves. On the policy front, an upgrade would depend on continued compliance with the government's precautionary standby arrangement with the IMF and progress on institutional integration with the EU.

We could revise the outlook back to stable if a fiscal overperformance, compared to our forecasts, does not occur; if the restructuring of public enterprises stalls; if the current account begins to widen anew; or if there are dislocations to the dinar foreign exchange market (due, for example, to a normalization of interest rates in the U.S.).

Source: Standard & Poor's.