Serbia 'BB/B' Ratings Affirmed; Outlook Stable

OVERVIEW

- We consider that Serbia's economic recovery is likely to continue at a healthy pace in 2018-2019, not least due to a favorable foreign direct investment outlook.
- Despite existing weaknesses in the public sector, we expect growth will support recent fiscal efforts and result in the gradual reduction of public debt.
- We are therefore affirming our 'BB/B' long- and short-term sovereign credit ratings on Serbia.
- The outlook is stable.

RATING ACTION

On June 15, 2018, 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.

OUTLOOK

The stable outlook balances the potential for further improvement in Serbia's external position and continued reduction of the public debt burden against contingent risks from the country's large public sector and potential volatility related to monetary policy normalization in advanced markets.

We might take a positive rating action if:

- Alongside strong exports growth, Serbia's resilience to external shock increased, signaled, for example, by lower external leverage or by a continuing drop in risks of sudden shifts in foreign direct investment (FDI) or portfolio investments, potentially as a result of continued reform momentum; or
- Serbia built a strong track record of keeping inflation in line with that of trading partners and the central bank's target.

Conversely, we could take a negative rating action if, contrary to our expectations, fiscal performance deteriorated, due, for example, to stalled restructuring of public enterprises putting Serbia's public debt on the upward path; or if balance of payments pressure re-emerged.

RATIONALE

The sovereign ratings on Serbia are constrained by its relatively low wealth levels; its large net external liability position, resulting from persistent current account deficits; still relatively high general government debt burden, a major part of which is denominated in foreign currency; and limited monetary policy flexibility, owing to the banking sector's euroization, which, although decreasing, is still substantial. At the same time, the ratings are supported by the favorable outlook for FDI and the government's improved budgetary position, which is buttressed by a demonstrated commitment to fiscal discipline.

Institutional and Economic Profile: Despite low wealth levels and weak institutions, we see potential for further reform. Serbia's investments, consumption, and exports will likely support economic growth of

about 3% in 2018-2019. That said, wealth levels remain low, with structural bottlenecks constraining faster income convergence. The EU accession process as well as a prospective new arrangement with the International Monetary Fund (IMF) could help advance reforms in Serbia, while locking in macroeconomic stability.

After almost a decade of lackluster performance, the Serbian economy's growth prospects look positive in the medium term. For 2018-2019, we expect real GDP growth will average 3% or higher. We consider that economic performance will be supported by healthy investment growth (highlighted by strong investment activity in the last few years and first-quarter 2018), driven by the pick-up of investment lending and improving investor confidence in light of macroeconomic stabilization. We expect private consumption will also boost growth as employment levels increase, wage growth accelerates, lending to households recovers, and the inflow of worker remittances benefits from a strong cyclical economic upturn in Europe. This is despite the temporary slowdown of Serbian growth in 2017 to just 1.9%, due to the one-off impact from adverse weather conditions, which hurt the agriculture, construction, and energy sectors. That said, Serbia's longer-term growth prospects are challenging and remain hampered by: unfavorable demographic trends, with the population shrinking by 0.5% per year--one of the fastest paces in the Western Balkans; relatively low labor participation; a large and only modestly reformed public sector; and material infrastructure gaps. Moreover, the effectiveness of Serbia's public institutions remains constrained by a weak judiciary, relatively high levels of perceived corruption, and low public governance standards (especially if compared with the EU average).

In this context, policy action--namely toward educational and pension systems, corporate governance in state-owned enterprises (SOEs), public administration, and the court system--if taken, could remove existing hurdles to economic development, leading to GDP growth rates well above our base-case forecast. From that perspective, the new policy-coordination arrangement with the IMF that the government is currently discussing could help to spur growth of Serbia's private sector and ensure sustainable income convergence. We believe that the presently strong global growth momentum and favorable credit conditions could present Serbia with a window of opportunity to address these long-standing issues. Absent growth acceleration, Serbia's U.S. dollar GDP per capita (our preferred income measure) will fluctuate around its pre-2008 crisis levels of a modest $6,700-$6,800--well below than that of the country's EU neighbors.

At the same time, we note the ongoing centralization of power, which gathered pace ahead of the presidential elections in 2017, accompanied by the increasing control of and restrictive actions toward independent mass media. The ruling party--the Serbian Progressive Party--currently controls the parliament, the presidency, and the majority of local councils (including in the capital city of Belgrade), and benefits from relatively high public support. Although the resulting political stability has supported commitment to fiscal consolidation and could amplify reform efforts, weaker checks and balances between key institutions might undermine policy predictability, resulting in weaker investor confidence going forward.

We anticipate, however, that Serbia's EU aspirations will likely constrain further power consolidation, even though the accession process might be lengthy and complex. Serbia was granted EU candidate status in 2012, and since then has opened 12 out of 35 chapters of the Acquis Communautaire, with two already temporarily closed. Meeting the conditions of some chapters will likely require difficult

political decisions. On top of the typical areas of concern for EU candidates, such as weaknesses with respect to the rule of law, Serbia will face some unique issues regarding its relations with Kosovo and trade agreements with Russia, which might trigger a public referendum and/or an early parliamentary election.

Flexibility and Performance Profile: Macroeconomic policy flexibility remains constrained, even with impressive fiscal effort and lower external imbalances.Serbia's external position has improved on the back of expanding export capacity, but vulnerabilities remain. Public finances are now at a more sustainable level, but we consider that further public debt reduction might require deeper reforms.We believe Serbia's national bank will likely maintain credible inflation control, but high euroization will continue to limit monetary policy effectiveness.

Serbia remains exposed to balance of payments risks, given its large net external liability position and persistent current account deficits. Yet, we note a positive trend, with external imbalances shrinking and the composition of current account financing improving. Strong FDI-induced merchandise and service exports has been the key driver behind this: between 2010 and 2017, in U.S. dollar terms, total exports almost doubled to about $22 billion (52% of 2017 GDP)--one of the strongest performances in the region.

Buoyant exports should mitigate pressures coming from expanding domestic demand, wide primary income account deficits, and higher global energy prices, in our view. Serbia's cost competitiveness is high, with the average wage at just one-quarter of the EU average. With a deepening integration into the European automotive industry's supply chains, Serbia's exports-oriented manufacturing sector will likely continue to enjoy high levels of FDIs. Additionally, we note solid performance of the country's information and communication technology (ICT) sector, which could also bolster Serbia's export capacity. The value of ICT exports has been expanding annually by over 20% on average in recent years and exceeded a sizable $1 billion in 2017 (some 2.4% of GDP).

For this reason, and despite wider current account deficits reported in 2017 (due to one-off weather-related factors and investment-related imports), we project Serbia will solidify its progress in reducing external imbalances, with current account deficits stabilizing at slightly above 4% of GDP in coming years. This is in stark contrast to a much weaker 8.7% of GDP reported on average in 2011-2014.

In line with the track record observed in 2015-2017, we expect that FDI net inflows will fully finance the current account deficits throughout the next 12 months. Under this assumption, external debt net of public and financial sector external assets (narrow net external debt) will decline gradually and stabilize at a moderate 52% of current account receipts (CARs) in 2018 compared with above 80% in 2012. With external debt now dominated by the public sector following years of private-sector deleveraging, we expect that gross external financing needs (annual payments to nonresidents) should remain roughly equal to CARs plus usable reserves.

At the same time, Serbia's net external liability position is quite large, owing to the accumulated stock of inward FDI (over 130% of CARs). Although FDI generally presents a much smaller risk than external debt, it still exposes the economy to potential swings in investor confidence, resulting in balance of payments pressure.

Serbia's fiscal outlook is now stronger than it was a few years ago, on the back of multiyear decisive consolidation efforts. These were framed by the precautionary stand-by agreement with the IMF, which was successfully completed in February 2018. The government reduced structural fiscal imbalances, and reversed the upward trajectory of public debt (in 2017 alone debt dropped by some 10% of GDP). The benign growth outlook as well as recovery in consumption-related tax receipts should support budget revenues and, provided costs are controlled, allow the general government deficit to average around 1% of GDP this year and next, compared with 6.6% of GDP in 2014.

That said, public debt net of liquid assets remains relatively high (56% of GDP at end-2017), especially considering Serbia's income levels. Reported debt includes government guarantees to SOEs (amounting to about 4.7% of GDP), some of which are self-supporting. Serbia's policy challenge is to rebuild fiscal buffers by reducing debt further, while improving the quality of public spending to support growth.

We consider this task a difficult undertaking for numerous reasons. Firstly, given a widening infrastructure gap and chronically anemic capital spending, pressures on the public investment budget will build and require control of recurrent costs through sensitive reforms of the pension system, healthcare, and public sector pay. Secondly, the relatively inefficient public sector might continue to pose moderate contingent fiscal risks. Large SOEs--namely Elektroprivreda Srbije, Srbijagas, and enterprises in the mining and petrochemical industries--still suffer from weak corporate governance, persistent energy arrears, and redundant employment. Progress in restructuring these SOEs has been relatively modest, with the privatization of Serbia's copper smelter (RTB Bor) planned for 2018 testing the government's commitment to reforming the sector. Thirdly, with almost 75% of general government debt denominated in foreign currency, principally euros and U.S. dollars, Serbia's public debt is sensitive to exchange rate shocks. Although the recent appreciation of the Serbian dinar has been beneficial for the debt metrics, monetary normalization in the eurozone will most likely put pressure on the currency and inflate government debt as well as its interest bill.

We find Serbia's monetary flexibility limited in several respects. Foreign exchange movements have a pronounced impact on the government's debt trajectory, on inflation pass-through, and on banks' asset quality. Such vulnerabilities have prompted the central bank, National Bank of Serbia (NBS), to intervene occasionally in the foreign exchange market to smooth the short-term exchange rate volatility. Pronounced appreciation pressures led the NBS to intervene by purchasing some €725 million (on a net basis) in 2017.

Furthermore, shallow local currency capital markets and the banking system's high euroization continue to constrain the NBS' ability to influence domestic economic conditions, given that nearly 60% of deposits and loans are denominated in foreign currency. At the same time, banks' profitability is recovering, and bank lending started to accelerate throughout 2017 and early 2018. This has been supported by sustained progress in the reduction of nonperforming loans (NPLs). Their nominal stock has halved, dropping to below 9% of total loans in April 2018 from more than 23% in 2015, reflecting the government's and the NBS' concentrated regulatory efforts and accelerated NPL write-offs. Despite notable improvements in 2017, the asset quality of state-owned banks' remains slightly weaker. At the same time, based on the NBS' data, we consider that the banking sector, otherwise predominantly foreign-owned, remains adequately capitalized and has sufficient liquidity.

The NBS has proved its operational independence and earned credibility over the past few years. Inflation declined to historical lows in 2014-2016, despite high exchange rate pass-through, with inflation expectations now well anchored. Rising food and energy prices will likely spur headline inflation through 2021, after a temporary slowdown in 2018, yet we expect it to stay within the NBS' target of 3±1.5%.

Source: Standard & Poor's.