

Serbia Outlook Revised To Positive On Stronger Growth And Improved Monetary Flexibility; 'BB/B' Ratings Affirmed

OVERVIEW

- We project that Serbia's solid growth will continue through 2021, while a new International Monetary Fund (IMF) arrangement should help anchor economic and fiscal stability.
- Despite high euroization of bank and government liabilities, Serbia's monetary authorities have delivered low and stable inflation, and local currency capital markets are gradually deepening.
- We are therefore revising our outlook on Serbia to positive from stable, and affirming our 'BB/B' sovereign credit ratings.
- The positive outlook signals our view that there is an increased likelihood that we will upgrade Serbia in the next 12 months.

RATING ACTION

On Dec. 14, 2018, 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.

OUTLOOK

The outlook revision reflects Serbia's solid economic growth outlook and largely prudent fiscal stance, amid prospects for delivery of further growth-enhancing reforms (including labor market reforms and additional privatization) under the new nonfinancial 30-month policy-coordination arrangement with the IMF that the government signed in July 2018. The improved outlook also reflects steps taken by the central bank to augment the credibility and effectiveness of its monetary policy and inflation-targeting regime; in our view, inflation expectations are now well-anchored, the exchange rate regime remains relatively flexible, and the largely foreign-owned banking system has been put on stronger financial footing, with nonperforming loans (NPLs) declining significantly and lending growth gathering pace.

We could raise our rating on Serbia in the next 12 months if strong growth continues, while public debt keeps declining and external imbalances remain contained.

Conversely, we could revise the outlook to stable if slowdown in the eurozone and tighter global financial conditions weaken Serbia's growth momentum, or cause external imbalances to recur; or if fiscal performance deteriorated putting Serbia's public debt on an upward path.

RATIONALE

Our ratings on Serbia are supported by its educated workforce, the favorable outlook for foreign direct investment (FDI), and the government's commitment to operating primary budgetary surpluses. Since 2015, Serbia has been paying down net external debt in absolute terms, while the size of the export sector has nearly doubled over the past decade to an estimated 52% of GDP by the end of this year. While some of this reflects the weakness of the domestic economy between 2009 and 2015, there is a clear relationship between large-scale foreign equity investment in key manufacturing and services sectors, and the strength of merchandise and services export growth. The services sector has operated under a surplus for eight consecutive years, with a surplus of about 2.5% of GDP last year. Moreover, since 2015, net FDI

has more than financed Serbia's current account deficits, enabling Serbia to reduce net external debt outright.

The sovereign ratings on Serbia are constrained by its relatively low wealth levels; its sizable net external liability position; and still-high general government debt burden, a major part of which is denominated in foreign currency. Our ratings also reflect the banking sector's extensive euroization, which, in our view, constrains monetary policy flexibility, despite authorities' improved track record on delivering low and stable inflation.

Institutional and Economic Profile: Despite low wealth levels and weak institutions, the new IMF arrangement should support reform momentum.

- Serbia's investments, private consumption, and exports will likely support economic growth of about 3.3% in 2018-2021.
- That said, wealth levels remain low, with structural bottlenecks constraining faster income convergence with the EU.
- The EU accession process as well as the policy-coordination arrangement with the IMF could help advance reforms in Serbia, while locking in macroeconomic stability.

The Serbian economy's medium-term growth prospects look positive. In 2018, real GDP growth is likely to reach a 10-year high of 4.2% or slightly above on the back of double-digit growth of investments, high export growth, and sustainable private consumption owing to improving labor market conditions.

Absent headwinds from a sharp slowdown in Europe, we expect the economy to expand by an average of 3% annually in 2019-2021 due to healthy investment growth, driven by the acceleration of public investments, the pickup in bank lending, and strong confidence supported by macroeconomic stability. 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 continued growth in Germany and Austria.

At the same time, Serbia's potential growth rates 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). Absent the forecast strong growth, Serbia's U.S. dollar GDP per capita (our preferred income measure) will fluctuate around its pre-2008 crisis levels of a modest \$7,200-\$7,300--well below than that of the country's EU neighbors.

In this context, policy action--namely toward rightsizing the public sector, addressing the shadow economy, and improving the independence of the court system--if taken, could remove some existing hurdles to economic development, leading to higher GDP growth rates than we currently expect. From that perspective, Serbia's new policy-coordination arrangement with the IMF could help spur growth of Serbia's private sector and speed up income convergence with the EU while preserving macroeconomic stability. Among other targets, the program focuses on reforming public employment and wage systems,

improving governance in state-owned enterprises (SOEs) and financial institutions, reducing informality, and raising labor force participation.

Serbia's increasingly centralized institutional settings and the resulting political stability have supported commitment to fiscal consolidation and could amplify future reform efforts. 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. At the same time, the increasing control of and restrictive actions toward independent mass media as well the politicization of the civil service have resulted in weaker checks and balances between key institutions. This might undermine policy predictability, resulting in weaker investor confidence.

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 16 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 unique issues regarding its relations with Kosovo and trade agreements with Russia, which might trigger a public referendum and an early parliamentary election.

Flexibility and Performance Profile: Prudent policy mix has reduced Serbia's fiscal and external imbalances significantly.

- Serbia's external position has been improving on the back of expanding export capacity.
- Public finances are now at a more sustainable level, with recent fiscal adjustment locked in by the new IMF arrangement.
- We believe Serbia's national bank has gained credibility due to effective inflation control.

Serbia remains exposed to balance of payments risks, given its large net external liability position and persistent current account deficits. However, we note a pronounced 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.

Goods export growth kept high pace in the first nine months of 2018 at about 8%, including manufacturing exports of about 10%, despite softer growth momentum in the eurozone and lack of visibility on FIAT's production plans after its existing investment agreement expires.

Buoyant exports should mitigate pressures coming from expanding domestic demand, higher global energy prices, and tightening global monetary conditions, 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 benefit from high levels of FDI. Additionally, we note the 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 (about 2.4% of GDP).

Throughout our forecast horizon, we expect the economy to continue to run current account deficits of about 5% of GDP, not least due the strength of the ongoing investment cycle. Yet external deficits of this magnitude are significantly lower those reported in 2011-2014 (about 8%-9% of GDP on average), when wide fiscal deficits were pressuring Serbia's current account position.

Importantly, we expect that FDI net inflows will fully finance the current account deficits, as was the case in the past three years. Under this assumption, external debt net of public and financial sector external assets (narrow net external debt is our preferred measures of external indebtedness) will stabilize at slightly above one-half of current account receipts (CARs) in 2018 and beyond--a sizable reduction compared with a relatively high 82% 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 in case of accelerated repatriation of profits and equity.

Serbia's fiscal outlook remains strong. We project another year of general government headline fiscal surplus in 2018 (about 0.6% of GDP) spurred by tax-rich demand-driven growth and one-off non-tax revenues. Given the government's recent strong record of fiscal prudence, we believe that going forward fiscal deficits should remain within 1% of GDP or slightly lower even against a background of moderating growth.

Over the past few years, the government reversed the upward trajectory of public debt. In 2017 alone, debt to GDP dropped by about 10 percentage points. That said, public debt net of liquid assets remains relatively high (slightly above 51% of GDP in November 2018), especially considering Serbia's income levels.

Serbia's policy challenge is to rebuild fiscal buffers by reducing debt further, while contained fiscal risks coming from the large and only modestly formed public sector. Large SOEs--namely Elektroprivreda Srbije, Srbijagas, and enterprises in the mining and petrochemical industries--still suffer from weak corporate governance and vested interests, persistent energy arrears, and redundant employment. Progress in restructuring these SOEs has been relatively modest, but could receive a boost from the recently completed sale of Serbia's copper smelter (RTB Bor). Additionally, 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 its debt metrics, monetary normalization in the eurozone could put pressure on the currency and inflate government debt as well as its interest bill.

We note improvements in Serbia's monetary flexibility. The National Bank of Serbia (NBS) has proved its operational independence and earned credibility over the past five years. Effective actions under the inflation targeting regime allowed it to anchor inflation expectations, despite a historically high exchange rate pass-through, resulting in low-single-digit inflation since late 2013. After picking up to 3.1% in 2017 due to a supply shock, headline inflation bottomed out in early 2018 on the high base effect and recovered to 2.2% in October owing to higher oil and food prices. Strengthening domestic demand and expected

hikes in administered prices will likely spur headline inflation through 2021, yet we expect it to stay within the NBS' target band of $3\pm 1.5\%$.

Serbia's exchange rate regime is relatively flexible to allow the economy to adjust to changing external conditions, while at the same time avoiding sharp swings in the real effective exchange rate. Due to the still-extensive euroization of the economy, NBS intervenes occasionally in the foreign exchange market to smooth short-term exchange rate volatility. Appreciation pressures led the NBS to intervene by purchasing about €1.6 billion (on a net basis) in the first 10 months of 2018. We nevertheless acknowledge the authorities' efforts to deepen the local currency debt markets, with the government stepping up dinar-denominated issuance and extending the maturity of the dinar yield curve to 10 years.

The profitability of Serbia's banking system is recovering, and bank lending has started to accelerate since 2017. This has been supported by sustained progress in the reduction of NPLs. Their nominal stock has more than halved, dropping below 6.4% of total loans in September 2018 from more than 23% in 2015, reflecting the government's and the NBS' concentrated regulatory efforts and accelerated NPL write-offs. Despite notable systemwide improvements, the asset quality of state-owned banks remains slightly weaker. Nevertheless, we consider that the banking sector, otherwise predominantly foreign-owned (about 70% of the total assets), remains adequately capitalized and liquid.

Source: Standard & Poor's.