Serbia Upgraded To 'BB+' On Resilient Macroeconomic Fundamentals; Outlook Positive

Overview

- Despite ongoing weakness in the eurozone, Serbia's GDP is set to expand by 3.6% in 2019 and almost 4% in 2020.
- Fiscal discipline will keep public debt contained, whereas monetary accommodation abroad and at home will help improve its profile.
- We are therefore raising our long-term sovereign credit rating on Serbia to 'BB+' from 'BB' and affirming the 'B' short-term rating.
- The outlook remains positive.

Rating Action

On Dec. 13, 2019, S&P Global Ratings raised its long-term foreign and local currency sovereign credit ratings on Serbia to 'BB+' from 'BB'. At the same time, we affirmed the 'B' short-term foreign and local currency sovereign credit ratings. The outlook is positive.

We also revised our Transfer and Convertibility (T&C) assessment to 'BBB-' from 'BB+'.

Outlook

The positive outlook reflects strong prospects for continued inflows of productive foreign direct investments (FDI), which could further widen and diversify Serbia's export base, strengthening its balance of payments' resilience to external shocks.

We could raise our rating on Serbia in the next 12 months if FDI continues supporting exports and GDP growth, also boosting its foreign exchange reserves, despite the muted growth outlook for the country's key trading partners. This scenario would be further supported by compliance with the IMF program reform targets, including those related to the introduction of the more binding fiscal rules.

Conversely, we could revise the outlook to stable if a protracted slowdown in the eurozone markedly weakened Serbia's growth momentum or caused external imbalances to recur. An outlook revision to stable could also arise if fiscal performance deteriorated, putting Serbia's public debt on an upward path.

Rationale

The upgrade reflects Serbia's resilient exports and investment-driven economic growth in the face of the challenging external environment. Serbia's remarkable departure from its previous track-record of weak and volatile growth has been accompanied by the reduction in macroeconomic imbalances: net public debt has gone down; net FDI has exceeded current account deficits supporting external deleveraging; and price and financial stability has been enhanced.

Serbia's macroeconomic fundamentals have strengthened markedly over the past three years. We believe that solid domestic demand, including the benign investment outlook, should help the economy to weather ongoing weakness in Europe. In addition, Serbia's monetary and fiscal policy settings have improved, partly due to past and existing arrangements with the IMF. This provides the authorities with room for policy maneuver in case external demand deteriorates further.

Moreover, with global and regional financial conditions likely to remain highly accommodative this year and next, we believe that imminent risks to Serbia's balance of payments from volatile capital flows have softened, whereas the government debt profile could further benefit from lower interest rates and longer maturities.

Our ratings on Serbia are supported by its educated workforce, the favorable prospects for FDI, the government's strong fiscal performance, moderate public debt, and credible monetary policy framework. The ratings are constrained by Serbia's relatively weak institutional settings, low wealth levels, sizable net external liability position, and the banking sector's extensive euroization.

Institutional and economic profile: Growth likely to remain resilient in 2020 and 2021

- Serbia's domestic demand will mitigate external weakness, supporting growth at about 4% in 2020.
- Wealth levels remain low, with structural bottlenecks constraining faster income convergence with the EU.
- The EU accession negotiations and the policy coordination arrangement with the IMF could help advance reforms, while locking in macroeconomic stability.

Contrary to our previous expectation, decelerating growth in the eurozone appears not to have undermined Serbia's economic performance. In fact, after a one-off supply-related weakness in the first half of 2019, the economy has accelerated, with real GDP expanding by 4.8% in the third quarter year on year. This was driven by strong domestic demand, supported by a double-digit growth in investments and vigorous private consumption on the back of improving labor market conditions and real wage gains. At the same time, quite remarkably, exports retained a strong momentum, expanding by almost 11%.

Even though we still believe that external headwinds will likely persist, we now project Serbia's GDP will expand by 3.6% in 2019 and almost 4% in 2020. This forecast factors in the solidity of domestic demand on the back of a buoyant labor market and continued investment activity supported by strengthening bank credit. We believe that in 2020 and early 2021, the pipeline of existing private investment projects as well as a modest fiscal stimulus in the form of accelerated capital spending and planned public wage and pension hikes should allow the economy to mitigate the fragile growth outlook for Serbia's key trading partners, Germany and Italy.

At the same time, Serbia's longer-term growth prospects are more challenging. Typical of the Western Balkans region, the country's potential output growth rates remain hampered by unfavorable demographic trends, with the population shrinking by 0.5% per year. A large and only modestly reformed public sector as well as material infrastructure gaps also curb potential expansion.

Moreover, the effectiveness of Serbia's intuitional setting 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 faster growth, Serbia's U.S. dollar GDP per capita (our preferred income measure) will not significantly exceed its pre-2008 crisis levels of a modest $7,500--well below 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 soften existing hurdles to economic development, leading to higher longer-term GDP growth rates than we currently expect. From that perspective, Serbia's policy-coordination arrangement with the IMF could help spur growth of Serbia's private sector and accelerate income convergence with the EU while preserving macroeconomic stability. 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, among other objectives.

Serbia's increasingly centralized public institutions have underpinned a commitment to macroeconomic policy prudence and some initial 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 it benefits from relatively high public support. However, 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, setting off a public backlash, with regular street protests in major cities. Even though we expect broader political continuity after the upcoming parliamentary elections in April 2020, further centralization of the institutional setup could, in our view, undermine longer–term policy predictability, potentially leading to flagging investor confidence. Another repercussion could be a brain drain--accelerated emigration of the most educated and skilled.

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 18 out of 35 chapters of the Acquis Communautaire (accumulated legislation, legal acts, and court decisions which constitute the body of EU law), 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 the Eurasian Economic Union, which might trigger a public referendum and increased political volatility.

Flexibility and performance profile: Serbia's fiscal and external imbalances continue to shrink

- Serbia's external position has been improving, owing to expanding export capacity.
- Public finances are now more sustainable, with recent fiscal adjustment locked in by the new IMF arrangement.
- We expect price and financial stability will be preserved.

Serbia's external profile has improved in recent years. This is partly a result of the country's success in deepening its integration into European supply chains via FDI in the export-oriented manufacturing and service sectors. Foreign investors have been taking advantage of Serbia's productive and relatively low-cost labor (the country's average wage is just one-quarter of the EU average), but also its restored macroeconomic stability. As a result, between 2010 and 2019, total exports have more than doubled to the equivalent of about $26 billion (an estimated 53% of 2019 GDP)--among the strongest performance in the region. Apart from the emergence of the export-oriented automotive cluster, we also note the solid performance of Serbia's service sector, including the information and communication technology (ICT) industry, business services, and transportation. ICT alone is expected to generate around one-fifth of total services receipts (about $1.5 billion, or about 3% of GDP) by end-2019, having expanded annually by over 20% on average in recent years.

Although the first three-quarters of 2019 saw sustained high export growth, we expect it to soften in 2020. This partly reflects decelerating global growth and as well as uncertainty over the production plans of the country's second-largest exporter, FIAT Chrysler.

Against the background of strong domestic demand (including buoyant investment growth, not least driven by acceleration of public capital spending), we expect the trade deficit to remain under pressure and the economy to run current account deficits of about 5.0% of GDP or slightly above in the medium term. At the same time, we expect external deficits to continue gradually declining (as new export

capacities come on line) and to contrast markedly with the average of 8%-9% of GDP reported in 2011-2014, when wide fiscal deficits squeezed Serbia's current account position.

Importantly, we expect that FDI net inflows will continue to fully finance the current account deficits next year, as was the case over the past five years, including 2019. Under this assumption, Serbia's external debt net of public and financial sector external assets will stay at a moderate level of slightly below one-half of current account receipts (CARs) in 2019 and beyond--a sizable reduction compared with a relatively high 82% in 2012.

Nevertheless, Serbia remains exposed to balance of payments risks given its large net external liability position, resulting in particular from the substantial accumulated stock of inward FDI (over 130% of CARs). Although FDI generally presents a much lower risk than external debt, it still exposes the economy to potential swings in investor confidence and disinvestment shocks, translating into balance of payments pressure in case of accelerated repatriation of profits and equity.

Notwithstanding long-term fiscal challenges to Serbia's public finances from adverse demographic trends and poor public infrastructure, including in transportation and waste and water treatment, we regard Serbia's fiscal policy as a credit strength. The recently passed 2020 budget preserves past fiscal adjustment gains and targets a modest deficit of 0.3% of GDP. Given strong employment and rising wages, meeting the government's target is unlikely to be difficult. In the first 10 months of 2019, the general government reported a headline fiscal surplus of over 1% of GDP spurred by strong tax and non-tax revenue growth. This follows outright headline fiscal surpluses in both 2017 and 2018, with the general government delivering one of the highest primary fiscal surpluses (about 3.2% of GDP on average) among all sovereigns we rate.

Going forward, we believe that fiscal deficits should remain within 1% of GDP or lower, even against a backdrop of moderating growth. In our view, alongside government's proven commitment to spending discipline, the fiscal outlook continues to be supported by the need for budgets until 2021 to be endorsed by the IMF, followed by the introduction of a new set of binding fiscal rules after the IMF arrangement expires. In the longer term, however, absent a more rules-based fiscal framework, shaping in particular the public wage system, fiscal risks could arise again.

Improved fiscal performance, declining interest rates, and currency appreciation have allowed the government to put public debt on a firm downward trajectory. Between 2015 and 2019, debt net of liquid assets to GDP dropped by 17.3 percentage points to just above 46% of GDP.

Serbia's government remains committed to bringing debt down further by preserving fiscal prudence and keeping fiscal risks from the large and poorly formed public sector under control. Large SOEs--namely Elektroprivreda Srbije and Srbijagas, in addition to mining and petrochemical companies--suffer from weak corporate governance and vested interests, persistent energy arrears, and redundant employment. Progress in restructuring these SOEs has been relatively modest, but received a boost from the sale of Serbia's copper smelter (RTB Bor) in 2018 and the government's commitment to resolve petrochemical enterprises in 2020 (including the privatization of MSK and Petrohemija) after fertilizer plant Azotara filed for bankruptcy earlier in 2019.

With over 70% of general government debt denominated in foreign currency, principally euros and dollars, Serbia's public debt remains sensitive to exchange rate shocks. At the same time, we recognize the government's efforts to otherwise improve its debt profile. Between 2015 and 2019, it has stepped up local currency borrowings, with dinar-denominated debt increasing to 28% of total debt; reduced its interest bill as a share of budget revenues by one-third to about 5%; and lengthened the average maturity of commercial debt to 4.3 years from 2.8 years. Importantly, around one-half of total debt remains concessional (bi- and multilateral), with relatively long maturities.

The National Bank of Serbia (NBS) has proved its operational independence, earning credibility over the past six years. Effective actions under the inflation-targeting regime has allowed the NBS to

anchor inflation expectations--despite a historically high euroization and past episodes of macroeconomic instability--and deliver low-single-digit inflation since late 2013. Headline inflation declined to 2% on average over 2018 on the high base effect and lower imported inflation. After picking up to 3.1% in April 2019 year on year, consumer price index growth eased to 1% in October due to lower energy and food prices. Given still low core inflation, which recently hovered just above 1%, consumer price growth has averaged 2% through most of 2019. A high base effect and imported disinflation will keep price growth at around this level or slightly below in 2020. Strong domestic demand and expected hikes in administered prices will likely spark a pick-up in headline inflation through 2022, but we expect it to stay within the NBS' target band of 3±1.5%.

Serbia's exchange rate regime is relatively flexible to allow the economy to adjust to evolving external conditions, while simultaneously avoiding sharp swings in the real effective exchange rate. Due to the still-extensive euroization of the economy, the 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 €2.35 billion (on a net basis) in January-November 2019. Foreign exchange interventions have helped NBS maintain both price and financial stability, as well as boost its international reserves to a record-high €13.5 billion ($15 billion). Progress in Serbia's de-euroization, or "dinarization," efforts has been relatively slow. Nevertheless, we acknowledge the decline in bank deposit euroization in recent years and gradual deepening of the local currency debt markets, with the government extending the maturity of the dinar yield curve to beyond 10 years. The potential inclusion of Serbia's bonds into the leading international emerging market bond indices could also support longer-term local-currency issuance.

The profitability of Serbia's banking system has recovered, with accelerated bank lending since 2017. This has been supported by sustained progress in the reduction of nonperforming loans (NPLs). Their nominal stock is almost 74% lower than in 2015, dropping to 4.7% of total loans in September 2019 from more than 23.0% in 2015, reflecting the government's and the NBS' concentrated regulatory efforts and accelerated NPL write-offs. Despite notable system-wide improvements, the asset quality of state-owned banks remains slightly weaker (with NPL levels exceeding system-wide average levels by a few percentage points). The forthcoming privatization of the third-largest bank, Komercijalna Banka, could in the longer term help address this issue. Nevertheless, we consider that the banking sector, otherwise predominantly foreign-owned (about 75% of the total assets), remains adequately capitalized, liquid, and domestic deposit-funded.