Serbia Outlook Revised To Stable From Positive On Economic Fallout Related To COVID-19; 'BB+/B' Ratings Affirmed

Overview

- We project that restrictions imposed on peoples' movements on account of the coronavirus pandemic will cause the Serbian economy to contract by 3.5% in 2020, before it rebounds in 2021.
- Consequently, the government's fiscal and debt metrics will deteriorate this year, as will the near-term outlook for non-debt-creating investment inflows into Serbia.
- We are therefore revising the outlook on our long-term ratings on Serbia to stable from positive.

Rating Action

On May 1, 2020, S&P Global Ratings revised its outlook on Serbia to stable from positive. At the same time, we affirmed our 'BB+' long-term and 'B' short-term sovereign credit ratings on Serbia.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on Serbia are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Calendar Of 2020 EMEA Sovereign, Regional, And Local Government Rating Publication Dates," published Dec. 20, 2019, on RatingsDirect). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the reason for the deviation is a significantly weaker domestic and external growth outlook. The next scheduled publication on the sovereign rating on Serbia is on June 12, 2020.

Outlook

The stable outlook balances the economic fallout from the COVID-19 pandemic--in the form of a more-adverse external finacing environment and deterioration in Serbia's growth and fiscal metrics--against the macroeconomic buffers the Serbian authorities have built up over the past half-decade, including higher foreign exchange (FX) reserves and more fiscal space.

Downward pressure could build on the ratings over the next 12 months if, contrary to our current expectations:

- We anticipated a far more significant weakening of Serbia's government finances. This could occur for instance if the growth outlook remained subdued for longer.
- Serbia became increasingly reliant on debt-creating foreign inflows to finance its external deficit.

Upward ratings pressure could build if foreign direct investment inflows continue into Serbia, supporting an improvement in its balance of payments resilience via rising export receipts and higher FX reserves.

Rationale

We project that Serbia's real GDP will contract by 3.5% in 2020 as a result of lockdown measures imposed to cope with the COVID-19 pandemic. There is a higher degree of uncertainty than usual attached to our forecasts.

Serbia has been in a state of emergency since mid-March with strict constraints on the movement of people and the closure of its international borders. A little over a month later, the authorities have started to lift some restrictions and reopen parts of the economy--for instance certain services, some retail avenues, and the construction sector--subject to social distancing norms.

Even with restrictions continuing to be gradually lifted over the next weeks, the ongoing need for individuals to maintain physical distance implies that economic output will not reach the level we previously forecast for 2021.

Moreover, Serbia's recovery will ultimately be tied to the fortunes of its key trading partners by virtue of the economy being more open than it was heading into the global financial crisis, more than a decade ago. Exports now constitute about half of overall economic output, compared to less than a third in 2007.

Foreign direct investment--predominantly in tradeables--has fully financed Serbia's wider current account deficits in recent years and lowered its reliance on debt-creating inflows. Arguably, these inflows have also aided the National Bank of Serbia's (NBS's) efforts to augment its FX reserves. Moreover, over the past decade foreign investment into Serbia's manufacturing sector has resulted in a strengthening of receipts from and diversification of the export basket. However, the nearer term outlook for foreign investment flows is fairly uncertain.

The government and the NBS have put together a package to contain the pandemic's economic fallout. The NBS cut the key policy rate by 75 basis points to 1.5% and increased the provision of liquidity to the banking sector via swap lines and repos. Of the measures announced by the government, the following will widen the fiscal deficit to nearly 7.0% of GDP in 2020 from 0.2% the year before:

- Deferrals of three months of labor taxes and social security contributions until 2021 (2.6% of GDP; this should largely reverse by 2022 given that Serbia's fiscal accounts are presented on a cash basis);
- Wage subsidies for private sector employees (1.8% of GDP);
- Cash transfers to adult citizens (1.3% of GDP);
- Wage increases for public healthcare workers, higher healthcare spending, and one-off payments to pensioners (0.6% of GDP); and
- A dividend moratorium until the end of the year (0.3% of GDP).

Other measures that will not immediately contribute to the deficit include state guarantees of about 5% of GDP for small and midsize enterprise loans via banks and Serbia's development fund. We have recorded these separately as guarantees and not included them in our projections for government debt, unlike guarantees extended to state-owned enterprises which are included in reported government debt.

Net general government debt-to-GDP, which has been on a declining trajectory since 2015, will rise to over 50% in 2020, from 45% in 2019, in line with our projections for the deficit. We flag that about 70% of Serbia's government debt is FX-denominated, making it vulnerable to exchange-rate volatility. We project that public finances will begin to consolidate in 2021 following a rebound in economic activity.

Nevertheless, Serbia is entering this crisis with significantly lower imbalances than it faced a decade ago. This is evidenced by its diminished reliance on temperamental portfolio inflows compared to the era after the global financial crisis when these flows were the dominant source of financing for its large twin deficits. Moreover, FX reserves reached a record high in January. The NBS has managed to curb inflation to under 2% over the past six years, well below the 10% average over 2003-2012. However, the restructuring of state-owned enterprises has yielded only modest success so far.

The stability of the majority foreign-owned banking sector has improved, although the euroization of deposits and loans remains high. The system's reported average capital adequacy ratio was 23.4% as of December 2019. Last year the sector was profitable and supportive of economic growth. Nonperforming loans declined to 4% of total loans from a peak of 22% in 2015, though some asset quality deterioration is likely this year. The sale of Serbia's third-largest lender, the state-owned Komercijalna Banka, to Slovenia's Nova Ljubljanska Banka is expected to be concluded by the end of this year.

Parliamentary elections, originally slated for April 2020, have been delayed until the state of emergency is lifted. Even though we expect macroeconomic policy continuity after the elections, we think the ongoing centralization of the institutional setup could undermine longer term policy predictability. This could in turn lead to flagging investor confidence. Another repercussion could be accelerated emigration of the most educated and skilled.

Our ratings on Serbia are supported by still-moderate public debt--yielding some fiscal space for the government to implement countercyclical policies--and a credible monetary policy framework. The ratings are constrained by Serbia's relatively weak institutional settings, comparatively low income and wealth levels, sizable net external liability position, and the banking sector's extensive euroization.

Source: Standard & Poor's.