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SERBIA 'BB+/B' RATINGS AFFIRMED; OUTLOOK STABLE

Overview

- We expect Serbia's fiscal deficit to remain elevated for longer than we had previously projected, with government net debt peaking at a still-moderate 56% of GDP in 2023 and declining thereafter.
- The economy has demonstrated broad resilience in the face of the COVID-19 related shock.
- We are therefore affirming our 'BB+/B' ratings on Serbia.
- The outlook is stable.

Rating Action

On June 11, 2021, 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 lingering risks from the COVID-19 pandemic to Serbia's fiscal performance over the next 12 months against the potential for the country's external position to strengthen, particularly if foreign direct investment (FDI) inflows remain resilient while the global recovery strengthens.

Upside scenario

We could upgrade Serbia if, alongside fiscal consolidation, Serbia's balance of payments performance proved stronger than we project. This could be the case if strong FDI inflows underpinned a further expansion of export-oriented productive capacity, reducing current account deficits and strengthening central bank international reserves.

Downside scenario

Downward pressure could build on the ratings if, contrary to our expectation, government finances weakened significantly or Serbia relied increasingly on debt to finance its external deficits as opposed to the current FDI-based funding structure.

Rationale

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 the country's relatively weak institutional settings, comparatively low economic wealth levels, a sizable net external liability position, and the still-extensive use of euros in the economy.

Institutional and economic profile: Less rigorous lockdown restrictions, substantial policy support, and the resilience of key sectors have limited the pandemic's effect on Serbia's economy

- We project real GDP will expand by 5% in 2021, supported in part by a third fiscal package.
- Nearly 40% of Serbia's population has received at least one vaccine dose, but risks related to vaccine efficacy against coronavirus variants remain and could weigh on economic growth and fiscal outcomes.
- With fresh elections due next year, the government's short two-year term could detract from its medium-term reform agenda.

We expect the Serbian economy to expand by 5% in real terms in 2021 after a relatively mild contraction of 1% in 2020. The number of employed continued to increase last year, although the fall in the unemployment rate was also attributable to workers exiting the labor market. The economy reached and exceeded its prepandemic level in the first quarter of this year.

Relative to many other countries, including in the region, Serbia had a much shorter period of stringent COVID-19-related containment measures. Authorities curbed subsequent waves of infection with fewer restrictions--for instance, via limits on business hours for most nonessential businesses and entertainment venues. Serbia's construction and manufacturing sectors remained resilient, and the economy's reliance on sectors most hit by the pandemic--such as leisure and hospitality--is limited.

Moreover, a sizable fiscal package and accommodative monetary policy supported the economy and prevented a deeper economic contraction. Amid rising infections earlier this year, authorities launched a third fiscal package that we anticipate will continue to support the economy this year.

Serbia has enjoyed relative success in its vaccination drive, with 37% of its population having received at least one jab so far. This performance makes the country one of the frontrunners in terms of vaccine rollout across emerging markets. Still, risks related to vaccine efficacy against virus variants could weigh on growth and fiscal outcomes. These risks could affect not just domestic demand, but also external demand for Serbia's exports--the economy is far 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 with less than a third in 2007.

Elections in June last year handed victory to the incumbent Serbian Progressive Party, which won three-quarters of seats in parliament. The main opposition parties boycotted the election, citing irregularities. This, along with the low voter turnout, prompted President Aleksandar Vucic to call elections in 2022. In our view, the government's short term in office could detract from its ability to implement its medium-term reform agenda. After the conclusion of its three-year policy coordination instrument with the IMF in January, the government is seeking another nonfinancial program to support structural reforms. These include strengthening tax administration and the management of fiscal risks, tackling the informal economy, and developing capital markets.

We continue to believe that the ongoing centralization of the institutional setup could undermine long-term policy predictability. This could, in turn, lead to flagging investor confidence. We also think that stemming the accelerating emigration of Serbia's most educated by creating adequate jobs across skill levels will remain an important test for subsequent administrations.

The resumption of U.S.-brokered talks between Serbia and Kosovo yielded an economic agreement, but a broader normalization of relations between the two--a prerequisite for Serbia's EU accession--is likely to remain a long-term challenge, in our opinion.

Flexibility and performance profile: Serbia entered the pandemic with significantly lower imbalances than a decade ago, providing policy headroom to support the economy

- Moderate levels of public debt afford some fiscal space for countercyclical measures to limit the pandemic's economic fallout.
- The banking system is stable, although we believe some asset-quality deterioration is likely as government forbearance measures wind down.
- Foreign exchange (FX) reserves are near record highs despite interventions by the National Bank of Serbia (NBS) to preserve the dinar's stability.

After providing sizable support to the economy through 2020 (about 12% of GDP including guarantees), the government revised the 2021 budget deficit to 6.9% of GDP from the original 3.0%. The budget revision incorporated a third economic support package that included:

- 1.3% of GDP in direct support measures to the private sector;
- 1.0% of GDP in untargeted cash transfers to citizens; and
- 1.6% of GDP in additional public capital expenditure (capex) targeting road and rail infrastructure, and military expenditure.

The package also includes 2% of GDP toward guarantees to small and midsize enterprises, which will not contribute toward the budget deficit unless called.

Net general government debt to GDP, which declined through 2015-2019, will rise to 53% in 2021 from 50% a year earlier, in line with our projections for the fiscal deficit. About 70% of government debt is FX-denominated, making it vulnerable to exchange-rate volatility.

We project that the fiscal deficit will begin to narrow in 2022 following a rebound in economic activity and the withdrawal of measures to support the economy during the pandemic. Political considerations ahead of the June 2022 elections could, however, further slow the pace of consolidation outlined in our projections. Authorities intend to continue increasing capex to close the infrastructure gap while aiming to guide public finances toward balance over the next five years, amid broader economic reforms. The revised 2021 budget includes 7% of GDP in capex projects, but whether the whole amount will be spent during the year is unclear.

Monetary policy has remained accommodative. The NBS cut the key policy rate by a cumulative 125 basis points to 1% during 2020 and increased the provision of liquidity to the banking sector via swap lines and repos. It has managed to keep inflation under 2% over the past seven years, well below the 10% average over 2003-2012 and its 3% target rate. We anticipate higher food and energy prices will boost inflation temporarily this year before it decelerates again.

The NBS also stepped up FX-market intervention through 2020 to stabilize the dinar. Reserve accumulation continued, nevertheless, and the NBS' FX reserves stand at close to record highs, at €14

billion at the end of May 2021. We estimate reserves (net of required reserves banks maintain with the NBS against their domestic FX liabilities) will cover four months of current account payments on average through our forecast to 2024.

More broadly, Serbia's imbalances are significantly lower than they were a decade ago. This is demonstrated by its diminished reliance on temperamental portfolio inflows compared with the era after the financial crisis, when these flows were the dominant source of financing for its large twin deficits. Moreover, and despite recent net foreign currency sales, the NBS' reserves reached a record high in May 2020. Fiscal imbalances have also receded in the past half-decade, although the restructuring of state-owned enterprises has yielded only modest success so far.

FDI--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 NBS' efforts to augment its FX reserves. In addition, over the past decade, foreign investment into Serbia's manufacturing sector resulted in stronger and diversified export receipts.

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 22% as of March 2021. The sector remains profitable--although returns have declined--and supportive of economic growth. Nonperforming loans declined to under 4% of the total at end-April 2021 from a peak of 22% in 2015, although we believe that some asset-quality deterioration is likely when official forbearance and support measures wind down. The sale of Serbia's third-largest lender, the previously state-owned Komercijalna Banka, to Slovenia's Nova Ljubljanska Banka (NLB), concluded in 2020. NLB now owns 88% of the entity.