Serbia Outlook Revised To Stable From Positive Due To Russia-Ukraine Conflict Fallout; Ratings Affirmed

Overview

- The Russia-Ukraine military conflict will weigh on Europe's economy, which represents many of Serbia's key trading partners.
- As a result, we expect Serbia's GDP growth to slow to 3% in 2022 and its fiscal and current account deficits to widen.
- Nevertheless, Serbia's relatively robust long-term growth prospects are supported by its credible policy framework.
- We have revised our outlook on Serbia to stable from positive and affirmed the 'BB+/B' foreign and local currency ratings.

Rating Action

On June 10, 2022, S&P Global Ratings revised its outlook on Serbia to stable from positive. At the same time, we affirmed our 'BB+/B' long- and short-term foreign and local currency sovereign credit ratings on Serbia.

Outlook

The stable outlook balances the rising macroeconomic risks stemming from the Russia-Ukraine conflict against Serbia's sound medium-term growth prospects supported by its credible policy framework.

Upside scenario

We could raise our ratings on Serbia should the macroeconomic fallout from the conflict prove to be contained. This could be signaled by Serbia's GDP growth, balance of payments, and public finances rebounding to their pre-conflict trajectories. An upgrade would also be contingent on subsiding geopolitical uncertainty.

Downside scenario

We could consider revising the outlook to negative if the Russia-Ukraine conflict had a graver and more protracted effect on Serbia than we currently expect, resulting in a significantly weaker growth outlook. This scenario would derail the government's fiscal consolidation plans and push up public debt. We could also lower the ratings should ongoing balance of payments weakness substantially undermine Serbia's foreign exchange (FX) reserve position.

Rationale

Previously, we expected continued strong post-pandemic growth in 2022, both in Serbia and its key trading partners in the eurozone and wider Europe, which led us to assign a positive outlook on Dec. 10, 2021 (see "Serbia Outlook Revised To Positive On Strong Economic Growth, Strengthening External Metrics; 'BB+/B' Ratings Affirmed," published on RatingsDirect). The Russia-Ukraine military conflict has substantially changed this assumption by stunting growth prospects and causing additional inflationary pressures in the region. Since the beginning of the conflict, we have revised our 2022 eurozone growth forecast down to 2.7% from 4.4% and our average annual inflation projection up to 6.4% from 2.0%. Despite limited direct trade and financial links to Russia and Ukraine, Serbia's small and increasingly open economy will inevitably take a hit, primarily through its exposure to Europe. As a result, we expect Serbia's GDP growth to weaken to 3% in 2022 compared to the 4.3% we projected in December 2021, and we also forecast the current account (CA) and fiscal deficits will widen.

Serbia's medium-term prospects remain reasonably resilient given its robust export and foreign direct investment (FDI)-driven growth model, supported by its proven macrofiscal and financial stability on the back of concerted policy efforts. Despite challenges posed by the two years of the global pandemic, Serbia entered 2022 in a strong position. Its real output exceeded the pre-pandemic level by over 6%, growth momentum in late 2021 and early 2022 was strong, public debt was declining, while the central bank's FX reserves and government liquidity buffers were at historical highs.

However, given the significant uncertainty over the duration and intensity of the conflict, as well as downside risks that the war poses for the region, we believe that immediate upside potential for our rating on Serbia has weakened.

Our ratings also factor in Serbia's moderate public debt levels and a credible monetary policy framework. They are constrained by the country's relatively weak institutional framework, comparatively low economic wealth levels, a sizable net external liability position, and high euroization in the economy.

Institutional and economic profile: GDP growth is set to decelerate in 2022 owing to the conflict in Ukraine

- After a strong recovery in 2021, we expect growth to soften in 2022 and rebound thereafter on the back of relatively strong export and investment expansion.
- Despite cultural ties, Serbia has minimal trade and financial exposure to Russia but continues to depend on Russian energy imports.
- Ongoing centralization of the institutional framework may weaken policymaking predictability.

GDP growth remained resilient in the first quarter of 2022, increasing by 4.4% compared with the same period last year. Nevertheless, we expect growth to decelerate to 3% in 2022 from 7.4% in 2021, primarily due to lower external demand tied to lower growth in Europe, and weaker domestic demand stemming from lower confidence and rising inflation weighing on private consumption. However, mitigating factors include a strong carry-over effect from the last quarter of 2021 and a healthy pipeline of FDI-financed projects. Downside risks to the growth outlook include an escalation in the Russia-Ukraine conflict; higher commodity prices; tightening financial conditions; or a sudden stop in energy supplies to Europe, resulting in weaker economic performance in Serbia's key trading partners, exacerbated by further supply chain disruptions.

From 2023, we expect growth to rebound to 3.5%-4.0% on the back of strong investment levels and recovering external demand. We therefore maintain our estimate of Serbia's medium-term growth potential of around 4% or slightly higher. Notably, gross fixed capital formation reached 22.5% of GDP in 2021, with the bulk of capital entering the tradable sectors, including manufacturing and some parts of the services sector.

Compared with some other economies in the region, Serbia's trade exposure to Russia and Ukraine is limited, which will help mitigate the direct spill-over from the conflict. In 2021, Serbia's exports to these countries combined totaled 1.9% of GDP and imports represented 3.3%, with a major part of imports from Russia comprising hydrocarbons. Although about one-third of Serbia's total energy imports and around 80% of its natural gas imports come from Russia, we believe that risks of possible flow disruptions are manageable. We base this on two factors. First, Serbia's oil and oil products imports are relatively diversified, with some 70%-80% of its import needs covered by countries other than Russia (namely Iraq and Kazakhstan). This will somewhat mitigate the negative implications for Serbia of the EU's partial ban on Russian oil. Serbia imports most of its oil via Croatia, the EU member state. Second, despite being highly dependent on Russia's gas, Serbia recently agreed a new three-year contract with Gazprom, which envisages a gas price considerably below the current spot level. Serbia imports gas via the Balkan Stream pipeline that runs through Bulgaria, which we understand is continuing to deliver to Serbia despite Russia's recent decision to suspend gas deliveries to Bulgaria.

Parliamentary elections were held in April 2022, with the Serbian Progressive Party (SNS) led by Aleksandar Vucic being reelected. However, the SNS secured 120 seats, falling short of the 126 seats needed for a majority. The turnout for parliamentary elections this year was 58.6%, much higher than the 49% in the 2020 election, which was boycotted by Serbia's main opposition parties. Since the parliamentary election results are yet to be confirmed, we expect a government to be formed in the next few months.

We expect a high degree of policy continuity, with the incoming government likely to advance reforms anchored by the ongoing non-financing Policy Coordination Instrument (PCI) with the IMF signed last year. The PCI aims to strengthen tax administration, manage fiscal risks, tackle the informal economy, and develop capital markets. That said, we believe that the ongoing centralization of the institutional setup could undermine long-term policymaking predictability. This may lead to weakening investor confidence. We also think that stemming the surge of Serbia's most educated people emigrating, by creating adequate jobs commensurate with skill levels, will remain key for subsequent administrations.

We anticipate that Serbia's EU aspirations could slow the ongoing centralization of the institutional framework, even though the accession process will likely be lengthy and complex. Serbia was granted EU candidate status in 2012, and since then has opened 22 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 provisionally closed. Meeting the conditions of some chapters will 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 foreign policy and trade agreements with non-EU members, including with Russia, which could trigger a public referendum and increased political volatility.

Flexibility and performance profile: Fiscal and external pressures will build this year

- The fiscal deficit will remain elevated at 4.5% of GDP in 2022, followed by fiscal consolidation thereafter.
- Serbia's CA deficits will largely be covered by net FDI inflows over the next few years.
- FX reserves remain adequate despite interventions by the National Bank of Serbia (NBS) to keep the dinar stable.

In 2021, Serbia's fiscal deficit narrowed to 4.1% of GDP, thanks to a large increase in revenues driven by a robust economic recovery. Despite stronger tax revenue collection, the authorities have recently adopted new fiscal initiatives. One-off bonuses to public sector employees, youths, and pensioners represented the pre-electoral spending cycle. On the other hand, other fiscal measures in the form of reduced excise duties on energy products were introduced to contain energy costs. We also expect additional spending pressures to stem from transfers to state-owned entities operating in the gas and energy sectors, due to increased input costs. Consequently, we estimate that the general government deficit in 2022 could exceed 4% of GDP (though the government might use flexibility around capital expenditure to contain overall spending growth and meet its 2022 deficit target of 3% of GDP). Despite higher borrowing requirements, government funding risks appear to be contained even in the face of an increasing cost of funding. This is thanks to Serbia's good market access and its ample cash buffers (almost 4% of GDP). Beyond 2022, we expect the government will likely revert to its conservative fiscal management and target a budget deficit of 1.5%-2.0% of GDP in the medium term, also anchored by the IMF arrangement.

Given the projected fiscal outlook, public debt net of liquid government assets will remain stable over the next years, at roughly 48-49% of GDP. Gross debt will decrease from about 54.8% of GDP in 2022 to roughly 53% of GDP by 2025 as the authorities will reduce some of their liquid assets. Despite the moderate debt levels, almost 72% of government debt is FX-denominated, making it vulnerable to exchange-rate volatility.

Serbia's CA deficit widened to 4.4% of GDP in 2021, driven by a large increase in imports. We expect the CA deficit to further widen to 6.4% of GDP in 2022, mainly due to higher commodity import prices and weaker demand for Serbia's exports. In line with historical trends, the CA deficit will continue to be financed largely by net FDI inflows. Over the past years, net FDI inflows have strengthened and diversified Serbia's export base, while also helping to foster external deleveraging and build up NBS' FX reserve position.

Similar to other economies, headline inflation has been rising sharply in Serbia, reaching 9.6% in April, mainly due to higher food and energy prices. The NBS initially responded by raising the average repurchase agreement rate via auctions (since October 2021), and subsequently by increasing the policy rate by a cumulative 150 basis points since April 2022. At the same time, the government has recently imposed price caps on selected basic foods and fuel to contain inflation. We expect inflation to subside somewhat in the second half of this year, but annual price growth to still average an elevated 9.2%. In the medium term, however, anchored medium-term inflation expectations on the back of NBS' improved credibility, as well as subsiding global food and energy price pressures, will help headline and core inflation to converge back to the NBS' target tolerance band of 3% plus or minus 1.5%.

Given the importance of the exchange rate for price and financial stability, the NBS has stepped up FX-market interventions over the past few months to mitigate currency depreciation pressures. The latter have been driven by FX demand from domestic energy importers as well as from households amid geopolitical uncertainty. Consequently, official FX reserves have decreased to €14.1 billion ($15.2 billion) in April, from €16.5 billion in December 2021. Regardless of these interventions, we project Serbia's FX reserves will remain adequate at roughly four months of CA payments in the medium term as market volatility subsides and global commodity prices normalize.

The NBS' timely resolution of the local subsidiary of Russia's SberBank, which fell under international sanctions, helped to preserve financial stability. More broadly, Serbia's banking sector is well-capitalized, profitable, and liquid. The system's reported capital adequacy ratio stood at a solid 20% in March 2022, whereas nonperforming loans hit a historical low of 3.4% of gross loans compared to a peak of 22% in 2015. However, the sector remains highly euroized, with euro-denominated deposits and loans accounting for slightly over 60% of total stocks.