# Serbia 'BB+/B' Ratings Affirmed; Outlook Stable

## Overview

- The adverse macroeconomic effects of the Russia-Ukraine war, including a sharp economic slowdown for its key trading partners, will weigh on Serbia's economy.
- We expect Serbia's GDP growth will slow to 2.1% in 2023 from 2.5% this year, and fiscal and current account deficits to remain elevated.
- Nevertheless, Serbia's credible macroeconomic policy framework, anchored by a new financing arrangement with the IMF in November 2022, as well as adequate foreign exchange reserves should help mitigate the fallout.
- We therefore affirmed our 'BB+/B' long- and short-term foreign and local currency sovereign credit ratings on Serbia and maintained the stable outlook.

## Rating Action

On Dec. 9, 2022, S&P Global Ratings affirmed its 'BB+/B' long- and short-term sovereign credit ratings on Serbia. The outlook is stable.

## Outlook

The stable outlook balances the rising macroeconomic risks from the Russia-Ukraine conflict and economic slowdown for the country's key trading partners, against Serbia's sound medium-term growth prospects and broadly conservative fiscal management, which is supported by its credible policy framework.

## Downside scenario

We could consider lowering our ratings if the Russia-Ukraine conflict and extended economic slowdown for key trading partners had a significant and more protracted effect on Serbia than we currently expect, resulting in pronounced repercussions for the medium-term growth outlook. This scenario would also disrupt the government's medium-term fiscal consolidation plans and result in higher public debt. Other downside triggers include a marked deterioration Serbia's foreign exchange (FX) reserve position, potentially from protracted balance-of-payments weakness.

# Upside scenario

We could raise our ratings on Serbia if we determine that the macroeconomic effects from the war in Ukraine and economic slowdown for Serbia's key trading partners are contained. Likely signals include an improvement in Serbia's growth prospects, external balances, and public finances. An upgrade would also depend on subsiding geopolitical uncertainty.

# Rationale

Earlier in the year, we revised our outlook on Serbia to stable from positive, due to the adverse spillovers and uncertainty brought about by the Russia-Ukraine conflict, including wider macroeconomic repercussions for the eurozone, Serbia's key trading partner. As a result, we lowered our growth forecasts for the country and widened both the fiscal and external deficits in 2022. Given the protracted nature of the war, we have now also revised down our growth projections for 2023, with real GDP expected to expand by just 2.1%, compared to 2.5% in 2022 and an average of about 3.5% in 2017-2021. In light of persistent increases in global energy and food prices, we have also revised our estimate of inflation up to 12% in 2022 and 11% in 2023.

Nevertheless, the conflict's effect on the Serbian economy and associated economic slowdown in Europe appears to be contained for now. Serbia's medium-term growth prospects remain resilient, supported by its growth model that is driven by exports and foreign direct investment (FDI). Additionally, the authorities have taken proactive policy measures this year to contain external and budget financing risks emanating from elevated energy prices, by reaching a two-year €2.4 billion ($2.39 billion) Stand-By Arrangement (SBA) with the IMF and securing concessional bilateral funding. The IMF program will also help contain fiscal slippages and provide extra buffers if needed.

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

# Institutional and economic profile: GDP growth is set to decelerate further in 2023, given the conflict in Ukraine and lower external demand

- Real GDP growth in the first half of 2022 was strong, but economic activity has slowed in the third quarter; we estimate full-year growth will drop to 2.5% from 7.4% in 2021.
- Growth will further decelerate to 2.1% in 2023, due to lower external demand, lower consumption, and tighter monetary conditions, but recover to average slightly above 3.0% in 2024-2025.

- The €2.4 billion IMF SBA program will help address fiscal and external financing needs while providing an anchor for policy prudence and reforms.

In the first two quarters of 2022, real GDP growth was robust, increasing roughly 4% year on year. Since then, weaker investment growth and a reduction in disposable income due to high inflation has slowed growth to 1.1% in the third quarter of this year, compared with the same period last year. We expect economic activity will remain weak for the remainder of the year, as a result, we estimate full-year real GDP growth of 2.5% in 2022.

In 2023, growth will soften to approximately 2.1%, due to a broad range of factors including lower external demand from Serbia's key trading partners, reduced consumption, and tighter monetary conditions. Roughly 64% of Serbia's exports went to the EU in 2021. And given our expectations of zero annual growth in the eurozone for 2023 (see "**Economic Outlook Eurozone Q1 2023: Reality Check**," published Nov. 28, 2022, on RatingsDirect), lower exports to the region will be a drag on growth for Serbia. Nevertheless, we maintain our growth forecast of about 3% over 2024-2025. Notably, gross fixed capital formation reached 22.5% of GDP in 2021, with the bulk of capital entering the tradable sectors, including manufacturing and parts of the services sector.

Before the conflict in Eastern Europe, Serbia's trade exposure to Russia and Ukraine was limited largely to the energy sector, and this has helped mitigate direct negative spillovers. Although about one-third of Serbia's energy imports and about 90% of gross natural gas imports originate from Russia, the risk of flow disruptions is remote, in our view. This is because, despite high gas dependence, Serbia agreed to a new three-year contract with Russia's Gazprom in May 2022, which includes a gas price considerably below recent spot prices. Serbia imports gas via the Balkan Stream pipeline that passes through Bulgaria and continues to deliver to Serbia, despite Russia's decision earlier in the year to suspend gas deliveries to Bulgaria. In addition, Serbian gas storage levels are full for the winter. Serbia's oil related imports are also relatively diversified. Before the conflict started, 70%-80% of the country's oil import needs were covered by countries other than Russia (namely Iraq and Kazakhstan) via the JANAF pipeline (Serbia's only crude oil pipeline) from Croatia. Given the EU's ban on Russian oil shipments from Dec. 5, 2022, Serbian authorities will be sourcing oil from other destinations, including the Middle East.

Parliamentary elections were last held in April 2022, with the Serbian Progressive Party (SNS) led by Mr. Aleksandar Vucic being reelected. However, the SNS secured 120 seats, falling short of the 126 seats needed for a majority. As a result, the SNS entered into a coalition with the Socialist Party to form a majority in government and a new cabinet was formed in October 2022.

We expect a high degree of policy continuity, with the new government likely to advance reforms anchored by the SBA program agreed with the IMF this year. The new €2.4 billion SBA program replaces the country's existing non-financing policy coordination instrument with the IMF. The SBA program aims to help Serbia address forthcoming external and fiscal financing needs in light of challenging global economic conditions. Furthermore, as a part of the SBA, structural reforms will have to be implemented, particularly in the energy sector where large state-owned enterprises (SOEs) operate.

Nevertheless, the ongoing centralization of the institutional framework could undermine long-term policymaking predictability. This may lead to weakening investor confidence. We also believe subsequent administrations will remain focused on creating adequate jobs across skill levels to halt the high levels of emigration of Serbia's most educated people.

Serbia's EU aspirations could slow ongoing centralization of institutions, but the accession process will likely be lengthy and complex. Serbia was granted EU candidate status in 2012, and since 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 decisions 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 persist through to 2023

- The fiscal deficit will remain elevated at 3%-4% of GDP in 2022 and 2023, primarily due to transfers to SOEs, but public finances will generally remain on a path of fiscal consolidation.
- Due to elevated commodity prices, Serbia will register its largest current account deficits since 2013, but most of these deficits will be financed by net FDI inflows.
- FX reserves have reached historical highs, with the National Bank of Serbia (NBS) acting as a net purchaser of FX so far this year.

Despite a windfall in tax revenue driven by higher inflation, costly transfers to SOEs operating in the energy sector (about 2% of GDP), one-off social transfers, the indexation of pensions, and higher capital expenditure costs are set to keep Serbia's fiscal deficit elevated at 3.9% of GDP in 2022, as per our estimate. The authorities recently revised up their 2022 budget deficit target to 3.8% of GDP from 3.0% earlier in the year.

Parliament recently passed the budget for 2023 and targets a fiscal deficit of 3.3% of GDP (in line with our estimates). On the expenditure side, notable expenditures include transfers to SOEs operating in energy worth about 1.2% of GDP, a hike in public sector wages, and an extension on the reduction of excise taxes on petroleum products. On the revenue side, we estimate roughly 0.3% of GDP (€160 million) worth of energy-related budget support in the form of a grant will be forthcoming from the EU. In addition, the authorities have increased the threshold for non-taxable income from Serbian dinar (RSD)19,300 (€165) to RSD21,712 (€185), which will reduce tax revenue.

The new budget has been designed to ensure to compliance with the IMF's SBA program requirements and will be financed via a mixture of domestic and foreign borrowing. Given rising interest rates globally, Serbia's 2023 gross financing requirements for the budget deficit will be met via primarily concessional borrowings, but will also come from market issuance, and include:

- A $1.0 billion bilateral loan from the United Arab Emirates;
- The €2.4 billion SBA program agreed with the IMF, however the authorities plan to use half of the available funds (€1.2 billion) and treat the remainder as precautionary;
- International financial institution (IFI) loans worth a total of £860 million, including loans from the World Bank, KfW, and French Development agency;
- Private placements or Eurobond issuance; and
- Domestic bond issuance.

Despite higher borrowing requirements, government funding risks appear to be contained, thanks to proactive efforts from the authorities, strong cash buffers (about 4% of GDP), and Serbia's strong relationships with IFIs. In addition, if needed, the authorities possess flexibility around capital expenditure to help contain costs. Beyond 2023, the government will likely continue a path of fiscal consolidation to

ensure compliance with the new legally binding fiscal rule from 2025 and target a budget deficit of roughly 1%–2% of GDP.

Considering the projected fiscal outlook, public debt net of liquid government assets will remain stable over the next years, at 46%-47% of GDP. Gross debt will decrease to roughly 51% of GDP by 2025 from about 52.8% of GDP in 2022. Compared with that of regional peers, Serbia's debt levels are moderate, but over 70% of government debt is FX-denominated, making it vulnerable to exchange rate volatility.

As a consequence of adverse terms of trade and weaker demand for Serbia's exports (primarily from the EU), we estimate the current account deficit will expand to about 8%-9% of GDP in 2022 and 2023, the highest external deficit since 2012. In line with historical trends, the deficits will continue to be largely financed 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 the NBS' FX reserve position.

Headline inflation has been accelerating in Serbia, reaching 15% in October, from 8% in January 2022. The acceleration in inflation is chiefly owed to higher food and energy prices. And to help contain second-round effects, the NBS has raised the policy rate by a cumulative 350 basis points so far in 2022. Simultaneously, the government has kept some price caps on selected basic foods and fuel to contain price growth. Price pressures will remain elevated in the near term, and we expect inflation to average 11.9% in 2022. Nevertheless, anchored medium-term inflation expectations thanks to the NBS' improved credibility, as well as subsiding global food and energy price pressures, will help headline and core inflation converge back to the NBS' target tolerance band of 3.0% plus or minus 1.5% in 2024.

In line with its mandate to maintain price and financial stability, the NBS has continued to intervene in the FX market to maintain relative stability of the exchange rate. Depreciation pressure emerged earlier in the year due to FX demand from energy importers and households amid geopolitical uncertainty. But strong net FDI inflows and residents' conversion back to the dinar among other capital inflows enabled the NBS to become a net purchaser of FX so far this year. FX reserves increased to €16.9 billion in October, up from €16.1 billion in January. We project Serbia's FX reserves will remain adequate at roughly four months of current account payments in the medium term, as market volatility subsides and global commodity prices normalize.

Earlier this year, the NBS swiftly resolved issues around the local subsidiary of Russia's SberBank, which fell under international sanctions, and helped to preserve financial stability. In general, Serbia's banking sector is well-capitalized, profitable, and liquid. The system's reported capital adequacy ratio stood at a solid 19.5% in September 2022, whereas nonperforming loans hit a historical low of 3.2% of gross loans compared with 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.