

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

Overview

- Both fallout from the Russia-Ukraine war and weakening European growth weigh on Serbia's economy, prompting us to project real GDP growth of 2.1% this year and expect that average inflation will remain high in 2023-2024.
- That said, Serbia's fiscal and current account deficits are set to narrow substantially on the back of lower energy prices and budgetary tightening.
- Net foreign direct investment (FDI) flows overfund the current account deficit, bolstering the central's banks foreign exchange reserve position, but euroization of the financial sector remains elevated.
- 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 Oct. 6, 2023, 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 reflects the balance between challenges from weaker external demand in Serbia's key trading partners in the EU, like Germany and Italy, its heavy dependence on Russian gas supplies, and, to a lesser degree, the economic uncertainties from the Russia-Ukraine war, against the country's long-term growth prospects and prudent fiscal management.

Downside scenario

We could consider lowering the ratings if an economic slowdown in Serbia's key EU trading partners, notably Germany and Italy, affects Serbia's growth prospects and the government's fiscal position more than expected, leading to an increase in public debt. Additionally, a significant drop in Serbia's foreign exchange reserves, perhaps from a commodity price shock or consistently weaker net FDI inflows, could serve as a downward trigger.

Upside scenario

If we determine that Serbia's growth outlook, external balances, and public finances are improving, and that the effects of the economic slowdown for Serbia's key trading partners dissipate, we may raise our ratings on the country. Less geopolitical uncertainty would also create ratings upside.

Rationale

Our ratings on Serbia are supported by moderate public debt levels and a credible monetary policy framework. Nevertheless, 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: Economic growth should recover in 2024 from this year's muted levels

- We expect real GDP growth to slow to 2.1% this year on tight financial conditions, high inflation, and lower external demand, before accelerating to about 3.0% from 2024.
- Serbia will remain heavily reliant on Russian gas supplies until alternative sources become available.
- The path to EU membership hinges on normalizing ties with Kosovo and aligning with EU sanctions on Russia.

We anticipate that multiple factors will drive a deceleration in Serbia's real GDP growth to roughly 2.1% in 2023 from 2.5% in 2022. A combination of relatively tight monetary policy and rising inflation will curtail consumption. Additionally, diminished external demand from Serbia's main trading partners, Germany and Italy, will likely keep growth suppressed, particularly since the EU accounts for roughly 64% of Serbia's exports. However, from 2024 on, growth will quicken to roughly 3% on average over 2024-2026, driven by improvements in the global economic landscape and stronger domestic investment and consumption.

Before the war in Ukraine, Serbia's trade ties with Russia were predominantly limited to the energy sector, thereby reducing direct negative spillovers. Historically, about a third of Serbia's energy and nearly 90% of its natural gas imports came from Russia. However, disruption risk is limited due to a favorable three-year contract with Gazprom. Although Russia halted gas deliveries to Bulgaria in 2022, the Balkan Stream pipeline, which supplies Serbia through Bulgaria, remains operational and still accounts for a significant portion of the country's gas consumption. Conversely, Serbia's oil imports are diverse, with 70%-80% sourced from countries other than Russia, such as Iraq and Kazakhstan, via the Janaf pipeline. Serbia has sought oil from alternative countries since the EU ban on Russian oil in December 2022.

Although Serbia's aspirations for EU membership anchor policymaking and foreign investor confidence, we think the path to accession will be complex and prolonged. Since obtaining EU candidate status in 2012, Serbia has only closed two of the 35 chapters of the Acquis Communautaire, the collective set of EU legislation and legal acts. On top of the typical areas of concern for EU candidates, such as weaknesses with respect to the rule of law, Serbia faces hurdles in the accession process, particularly with the normalization of relations with Kosovo and Serbia's lack of alignment with EU sanctions against Russia.

Due to the Russia-Ukraine conflict, the Western Balkans has gained strategic importance for the EU, particularly for regional security. Rising tensions between Serbia and Kosovo, especially in Northern Kosovo, have prompted the EU and U.S. to ask both parties to normalize relations. A recent EU-backed draft agreement between Serbia and Kosovo includes mutual recognition of documents, establishment of permanent missions, restrictions on representing each other internationally, and the establishment of an association of Serb municipalities in Northern Kosovo.

In our view, there is some uncertainty on whether the draft agreement will be formally signed and executed. This agreement is essential for Serbia's and Kosovo's EU membership aspirations, but only about 33% of Serbians support EU membership. There have been protests against the agreement, and

tensions persist between Serbia and Kosovo. However, Serbia's economic prospects are tightly linked to those of the EU, the key destination of Serbia's exports and emigration and the primary source of imports, net FDI and remittances. The EU plans a donor conference for both nations but has stipulated that funds depend on the agreement's execution.

The EU also highlights Serbia's noncompliance with its sanctions on Russia as an obstacle to its membership bid. Despite Western pressure to sanction Russia, according to polls, many Serbs oppose it. Serbia's dependence on Russian gas, though diversification efforts are underway, further complicates matters. Therefore, Serbia's EU accession progress will likely depend on both the outcome and implementation of the EU-backed agreement with Kosovo as well as its alignment with EU sanctions against Russia. We do not expect a breakthrough over the coming year.

In that time, policymaking will likely remain stable under President Alexander Vucic's administration. The €2.4 billion Stand-By Arrangement (SBA), established with the IMF in late-2022, underpins our opinion. It is designed to tackle external and fiscal challenges in a challenging global economy, and it mandates structural reforms, especially in the energy sector where significant state-owned firms like Elektroprivreda Srbije (EPS) and Srbijagas are active.

Flexibility and performance profile: Fiscal and external pressures have eased

- We expect the government to meet its fiscal deficit target of 2.8% of GDP this year, versus the 3.3% it initially planned.
- Lower commodity prices and dampened demand for imported merchandise goods will more than halve the current account deficit this year from the high 6.9% of GDP in 2022.
- Net FDI inflows continue to overfinance the current account deficit, enabling the central bank to increase its foreign exchange reserves to historical highs.

The government has revised its fiscal deficit target for the year to 2.8% of GDP, from the initially planned 3.3%. This revision is primarily due to reduced expenditure and higher-than-anticipated revenue. The decrease in expenditure stems from reduced energy subsidies to state-owned enterprises (SOEs), on the back of lower global energy prices, with only about 50% of the allocated budget being used. The revised budget introduces spending measures that amount to approximately 1% of GDP and include hikes in pensions, public sector wages, and additional agricultural subsidies. However, these measures will be covered by excess revenue and savings from a reduction in energy subsidies.

The government's revised budget aligns with the IMF's latest SBA program targets. Despite moderate gross financing requirements for 2023, funding risks are manageable, given that a significant portion of the financing is already secured. By July 2023, government cash reserves stood at a sizable 11.2% of GDP. Furthermore, the authorities can adjust capital expenditure to manage costs, if needed. The government aims to continue fiscal consolidation, adhering to the new fiscal rule from 2025 that targets a budget deficit of 1%-2% of GDP. Our projections imply general government deficits of 1.5% from 2025 and hinge on our assumption of reduced fiscal transfers to SOEs, particularly in the energy sector, due to recent domestic utility price hikes and sectoral reforms, both central to the IMF program.

Based on our projected fiscal and economic outlook, general government debt net of liquid assets will drop to roughly 44% of GDP in 2024, stabilizing around this level thereafter. Compared with that of its

peers, Serbia's debt levels are moderate. However, over 70% of the government debt is denominated in foreign currency, subjecting it to exchange rate volatility.

With declining commodity prices, resilient goods exports, and lower merchandise imports, we expect Serbia's current account deficit to shrink notably to 2.9% of GDP in 2023, from 6.9% in 2022. Although we expect the current account deficit will subsequently return to nearly 5% of GDP on average over 2024-2026, we expect net FDI inflows will continue to comfortably cover the deficit. FDI inflows have significantly contributed to expanding and diversifying Serbia's export base and reducing external debt. They have also enabled the National Bank of Serbia (NBS) to strengthen its foreign exchange reserve position. International reserves surged 39% to €25.7 billion (\$27.0 billion) in the 12 months ended August 2023, and we expect reserves to remain broadly stable.

Due to higher energy and food prices, inflation peaked in March at 16.2%. However, price pressure has eased since then, with inflation dropping to 11.5% by August. Serbia's slower decline in inflation than other countries' can be partly attributed to utility price hikes as a part of the IMF program. To prevent the emergence of second-round effects, the NBS has continued to moderately hike the policy rate since the beginning of the year, raising it by a cumulative 150 basis points to 6.5%. Even if we expect headline inflation to continue decelerating for the remainder of the year, in annual average terms, we project inflation to remain high at 12.4% this year. However, we assume inflation will drop from 2024, somewhat anchored by the NBS's credibility, a tight monetary policy stance, and stable exchange rate against the euro. Furthermore, with global food and energy price pressures subsiding, we anticipate both headline and core inflation to converge to the NBS' target tolerance band of 3.0% plus or minus 1.5% in the second half of 2024.

Overall, the banking sector in Serbia is well capitalized, profitable, and liquid. In June, the system's reported capital adequacy ratio was at a strong 22.3%, while the nonperforming loans ratio reached a historical low of 3.0%. However, given the present economic downturn and rising interest rates, we anticipate a short-term rise in the nonperforming loans ratio. Additionally, the issue of high euroization persists, with euro-denominated deposits and loans accounting for more than 50% of total stocks.