Serbia 'BB-/B' Ratings Affirmed On Prospects For Reform; Outlook Remains Negative

Overview

- The outcome of Serbia's general elections on March 16, 2014, has created a more favorable political environment in which to embark on overdue fiscal consolidation and structural reforms.
- In our view, policymaking in the near term will focus on containing any further deterioration of public finances.
- We are therefore affirming our 'BB-/B' long- and short-term sovereign credit ratings on the Republic of Serbia.
- The outlook remains negative, which reflects our view of significant downside risks to public finances if reforms are not passed in a timely and effective manner or if financing conditions worsen.

Rating action

On April 11, 2014, Standard & Poor's Ratings Services affirmed its long- and short-term foreign and local currency sovereign credit ratings on the Republic of Serbia at 'BB-/B'. The outlook is negative.

Rationale

The ratings are constrained by high fiscal and external deficits, which expose Serbia to refinancing risks. The ratings are also constrained by Serbia's moderate GDP per capita and limited monetary policy flexibility, owing to the high euroization of the economy. The ratings are supported by Serbia's long-term economic growth potential. However, we believe the government will only unlock this potential with reforms to the labor market, the business environment, and public administration.

The March 16 general elections yielded a landslide victory for the Serbia Progressive Party (SNS), which doubled its parliamentary majority, winning 48% of the vote and 63% of the seats in parliament. With a comfortable absolute majority, the SNS could choose to govern alone and would face fewer obstacles in formulating legislation. Designated prime minister Aleksandar Vucic has, however, signaled a willingness to form a coalition with one or two smaller parties. A coalition could marshal greater public acceptance of controversial reforms and austerity measures.

In our view, the immediate policymaking challenges are vast, especially for fiscal consolidation. The government faces measures such as shrinking the public-sector wage bill; lowering subsidies to state-owned enterprises (SOEs) and improving their profitability (the government intends to wind down or privatize 179 SOEs in coordination with the World Bank); and improving tax collection and administration. It remains unclear whether Serbia will sign a new agreement with the IMF to anchor these measures.

We expect the government to reduce its persistently high headline deficits gradually. That said, we believe the general government deficit will increase to 6.9% of GDP in 2014 given that most consolidation measures will not begin to take effect until the next year and the state already incurs some expected costs associated with the restructuring of SOEs.

For 2015-2017, we forecast an average deficit slightly above 4% of GDP. These deficits, along with a small depreciation of the dinar, will push net general government debt to 51% of GDP in 2014 from 25% in 2009. These figures do not include the currently 8% of GDP in government-guaranteed debt that the government is increasingly servicing on behalf of loss-making SOEs. Around 74% of the general government debt is denominated in foreign currency, and about 62% of commercial debt is held by nonresidents, making the debt-to-GDP ratio sensitive to exchange rate fluctuations. Interest expenditure has increased to an average of more than 7% of consolidated general government revenue in 2014-2017, from less than 2% in 2009.

The government has also laid out a structural reform agenda beyond SOE restructuring. This aims to improve labor market efficiency, strengthen pension system finances, and reform bankruptcy law. We expect such structural reform measures to eventually boost economic growth by improving the business environment and government effectiveness, but not profoundly so over the 2014-2017 forecast horizon.

Serbia's economic rebound last year was on strong export growth, mostly fuelled by the automotive and agricultural sectors. For 2014, we expect that growth will slow on a further decline in consumption, amplified by expected budgetary consolidation and burdened by high unemployment of close to 25% (employment is at 45%). Further, due to a higher base effect, net exports will contribute less to overall growth than in 2013 while we project investment activity to increase only marginally and remain, in real terms, well below the 2007 and 2008 peaks. With GDP per capita at $6,400, Serbia remains poorer than any of its EU neighbors and Montenegro, but ahead of the other Balkan republics.

Inflation returned to the central bank's target range of 2.5%-5.5% late in 2013 and should remain at the upper end of the band in 2014-2015. The compression in domestic demand has also left imports stagnating, which, along with strong exports, has contributed to a reduction in external imbalances. Positively, the current account deficit narrowed significantly to just below 5% of GDP in 2013, but we forecast a slight widening to an average of 6% in 2014-2017.

We estimate Serbia's 2014 gross external financing requirement at $11.4 billion (43% of current account receipts). We project that 85% of the current portion of private-sector external debt will be refinanced ($5.4 billion), all short-term external debt ($1.8 billion) will be rolled over, and foreign direct investment will remain at 2013 levels ($1.2 billion). We project that the public sector will raise the remaining requirement ($3.3 billion): half through official borrowing, and half through eurobond issuance, portfolio flows to the domestic government bond market, and, if needed, a drawdown of external fiscal assets.

Exchange rate fluctuations remain a vulnerability and this has prompted the National Bank of Serbia to pursue a more restrictive monetary policy than its inflation targeting would suggest. As a floating currency, the dinar provides a flexible adjustment mechanism, but a history of high inflation and political challenges to central bank independence limit the credibility of monetary policy, in our opinion.

Under our criteria, we have revised our transfer and convertibility (T&C) assessment upward to one notch above the sovereign foreign currency rating. This is because we view the likelihood of the sovereign restricting access to foreign exchange needed for nonsovereign debt service as being slightly less than the likelihood of the sovereign defaulting on its foreign currency obligations. In other words, we consider Serbia's foreign exchange regime to no longer be very restrictive, and we believe it is in the process of opening further, similar to peers in the Western Balkans.

Outlook

The outlook remains negative, reflecting our view that there is at least a one-in-three chance that we could lower the ratings within the next 12 months if the government does not implement the policies that we expect will stabilize, and eventually ease, its debt burden; if external financing becomes more costly, either because bank rollover rates fall below our expectations or because the public sector's access to markets weakens; or if the central bank adopts a more interventionist foreign exchange policy.

The ratings could stabilize at the current levels if the reforms, which we understand the government is announcing this quarter, consolidate public finances in a sustainable way, leading to stronger economic prospects and a sustainable external position over the medium term.

Source: Standard & Poor's.