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Serbia 'BB-/B' Ratings Affirmed; Outlook Positive

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OVERVIEW

Economic recovery, policy commitment, and a precautionary standby agreement with the International Monetary Fund continue to support Serbia's ambitious fiscal consolidation agenda.

We are therefore affirming our 'BB-/B' sovereign credit ratings on Serbia.

The positive outlook signals that we could raise our ratings on Serbia if the government overperforms on its fiscal metrics while keeping the current account deficit in check.

RATING ACTION

On June 16, 2017, S&P Global Ratings affirmed its 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on Serbia. The outlook remains positive.

RATIONALE

The ratings on Serbia are constrained by relatively low wealth levels; a high general government debt burden, most of which is denominated in foreign currency; limited monetary policy flexibility, owing to the banking sector's prevalent euroization; and the country's still-sizable stock of nonperforming loans (NPLs). At the same time, favorable economic growth potential and consistent commitment for fiscal consolidation support the ratings.

The Serbian economy is likely to expand in 2017-2019, on the back of healthy investment inflows--mainly foreign direct investment (FDI)--and stronger private sector consumption supported by expanding employment, wage growth, and a stable inflow of worker remittances. Our current assumption is that Serbia will likely see strong performance in 2017 similar to 2016 levels, despite some slowdown in growth reported in first-quarter 2017 (just 1.2% year-on-year), which likely stemmed from a one-off impact of adverse weather conditions.

That said, Serbia's long-term growth potential remains hindered by a large and only a modestly reformed public sector, poor demography, and low labor participation. In this context, structural reforms (namely to pensions, corporate governance in state-owned enterprises, public administration, and the judicial system), if implemented, could improve the country's growth potential well above our base-case forecasts, which average 2.8% between 2017 and 2020.

On a per-capita basis for the same period, we forecast Serbia's average real GDP growth to be slightly higher at about 3%. This is due to the population shrinking at an estimated 0.5% per year. Still, GDP per capita remains moderate at $5,400 in 2017. This is lower than that of Serbia's EU neighbors due to past periodic sharp depreciations of the Serbian dinar.

Economic recovery, a policy commitment to cost containment--framed by a precautionary standby agreement with the International Monetary Fund (IMF)--and one-off revenues helped the government to lower the general government deficit to 1.3% of GDP in 2016, about one-fifth of the level in 2014. This achievement underlines the government's commitment to fiscal consolidation, which we believe could in principle go even further.

A number of challenges continue to pose a risk to further fiscal adjustment, however. First, structural improvements will require deeper reforms of the public sector, including restructuring or improving corporate governance in several large state-owned enterprises (SoEs)--namely Elektroprivreda Srbije, Srbijagas, and enterprises in the mining and petrochemical industries. SoEs have been the major driver behind the past growth of government debt and still could represent significant, albeit diminished, fiscal risks. A possible second obstacle to additional fiscal adjustment is the limited visibility on whether the IMF program, which runs out in early 2018, will be followed by a new agreement. The program has so far served as a very reliable policy anchor to government fiscal efforts. Third, following recent presidential elections, the incoming primer minister's commitment to fiscal reforms will have to be tested, as the government approaches the new budget cycle and faces pressure from pre-election expenditure proposals, including those on public salary hikes.

Considering these challenges, we forecast average fiscal deficits of about 1.9% on average over 2017-2020, and a corresponding annual rise in general government debt (our preferred fiscal metric) of about 3% of GDP higher, given our expectations regarding foreign exchange movements and some modest support for public enterprises. At the same time, we still expect general government debt to gradually decline to a still high 70% of GDP by 2020.

We note a recent positive trend in terms of external imbalances. From an average of 8% of GDP in 2011-2014, we expect Serbia's current account deficit to average 4% of GDP in 2017-2020, with strong merchandise and service exports a key driver behind this improvement. We see further upside potential as a significant amount of FDI has entered the manufacturing sector, taking advantage of Serbia's lower cost structure. Looking at the current account from a savings-investment perspective, we believe the improved fiscal performance will also relieve pressure on the country's overall current account position.

In addition to declining current account deficits, we expect the composition of external financing to improve. With the opening of EU accession talks in late 2015, we expect that FDI net inflows will fully finance the current account deficits throughout our 12-month forecast horizon. Under this assumption, external debt net of public and financial sector external assets (narrow net external debt) will decline gradually to below 50% of current account receipts (CARs) in 2020 from 72% in 2015. Regarding the composition of external debt, we have observed a pronounced halt of external finance for the private sector. Unlike a few years ago, the financial sector is now in a net creditor position and net external non-financial private sector debt has reduced. These outflows were financed by rising public sector external debt, FDI, and, to a small extent, by the depletion of official reserves. We believe that this trend has now run its course, based on the stabilization of funding of the foreign banks that own most of the Serbian banking sector, as well as improved fiscal prospects. With this mix of external debt, we expect that gross external financing needs should remain roughly equal to CARs plus usable reserves.

We find Serbia's monetary flexibility limited in several respects. Foreign exchange movements have a pronounced impact on the government's debt trajectory, on inflation pass through, and on bank asset quality. Such vulnerabilities have prompted the central bank, National Bank of Serbia (NBS), to intervene in the foreign exchange market occasionally. Almost 80% of general government debt is denominated in foreign currency, principally euros and U.S. dollars.

Further, high euroization of the banking system continues to undermine the effectiveness of monetary policies, as nearly 60% of deposits and loans are denominated in foreign currency. NPLs represent another longer-term challenge. Despite a drop in NPLs to 16.8% in first-quarter 2017 from more than 21% at the end of 2015, reflecting the government's and NBS' regulatory efforts and recent NPL write-offs, their stock remains relatively high (especially in state-owned banks). Credit losses continue to weigh on banks' profitability and constrain their lending capacity. At the same time, the NBS' Special Diagnostic Studies report indicated that the banking sector remains adequately capitalized and has sufficient liquidity.

Nevertheless, NBS has proved its operational independence and earned credibility in the past few years as inflation has declined to historical lows in 2014-2016 despite high exchange rate pass-through. Rising food and energy prices will likely spur headline inflation throughout the forecast horizon, yet we expect it to stay within the NBS' target of 3±1.5%.

OUTLOOK

The positive outlook signals that we see an increasing likelihood that we would raise our rating on Serbia during the next six to 12 months if the new government's fiscal performance exceeds our expectations. Stronger export performance or further reduction in risks of sudden shifts in FDI or portfolio investments, potentially as a result of continued reform momentum, could also prompt a positive rating action. Furthermore, sustained success in keeping inflation in line with trading partners and the central bank's target could also support a rating upgrade.

We could revise the outlook back to stable if fiscal and external deficits widened compared with our forecasts, due for example to spending pressures and stalled restructuring of public enterprises; if the current account begins to widen anew; or if there are dislocations of the dinar foreign exchange market.

KEY STATISTICS

Table 1

Republic of Serbia Selected Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. RSD)	3,408	3,584	3,876	3,908	4,043	4,200	4,439	4,695	4,972	5,259
Nominal GDP (bil. $)	46	41	46	44	37	38	38	40	41	43
GDP per capita (000s $)	6.4	5.7	6.4	6.2	5.2	5.3	5.4	5.7	5.9	6.2
Real GDP growth	1.4	(1.0)	2.6	(1.8)	0.8	2.8	2.8	2.9	2.8	2.7
Real GDP per capita growth	2.2	(0.5)	3.1	(1.4)	1.3	3.1	3.1	3.2	3.1	3.0
Real investment growth	4.6	13.2	(12.0)	(3.6)	5.6	4.9	6.0	7.0	6.0	5.0
Investment/GDP	20.1	21.0	17.6	17.5	18.9	18.1	18.7	19.1	19.4	19.8
Savings/GDP	9.2	9.4	11.5	11.5	14.1	14.0	14.8	15.0	15.3	15.7
Exports/GDP	34.0	36.9	41.2	43.4	46.7	50.9	53.7	55.4	57.1	58.9
Real exports growth	5.0	0.8	21.3	5.7	10.2	11.9	9.2	7.0	7.0	7.0
Unemployment rate	23.0	23.9	22.1	19.2	17.7	13.0	12.0	12.0	12.0	12.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(10.9)	(11.6)	(6.1)	(6.0)	(4.7)	(4.0)	(3.9)	(4.1)	(4.1)	(4.1)

Current account balance/CARs	(24.3)	(23.8)	(11.6)	(10.7)	(7.8)	(6.3)	(5.9)	(6.1)	(5.9)	(5.8)
CARs/GDP	45.1	48.6	52.8	55.6	60.0	63.3	66.1	67.6	69.0	70.8
Trade balance/GDP	(16.5)	(17.8)	(12.1)	(12.4)	(11.9)	(10.2)	(10.7)	(10.7)	(10.9)	(11.1)
Net FDI/GDP	9.9	2.4	3.8	3.7	5.4	5.5	5.0	5.0	4.8	4.4
Net portfolio equity inflow/GDP	0.2	(0.1)	(0.1)	(0.1)	(0.2)	(0.1)	0.0	0.0	0.0	0.0
Gross external financing needs/CARs plus usable reserves	122.9	110.3	105.2	98.8	98.9	98.0	101.4	98.3	97.8	97.6
Narrow net external debt/CARs	64.3	82.2	73.6	70.3	71.6	65.4	61.0	55.2	51.5	48.6
Net external liabilities/CARs	153.6	177.9	176.8	161.8	168.2	157.0	155.7	151.2	148.1	144.6
Short-term external debt by remaining maturity/CARs	51.2	47.1	40.5	34.7	33.8	29.6	31.3	25.9	23.9	22.6
Usable reserves/CAPs (months)	4.1	5.3	4.8	5.1	4.8	4.4	4.0	3.9	3.7	3.6
Usable reserves (mil. $)	10,894	10,707	11,601	9,629	9,235	8,857	9,191	9,340	9,639	9,759
FISCAL INDICATORS (%, General government)										
Balance/GDP	(4.8)	(6.8)	(5.5)	(6.6)	(3.7)	(1.3)	(1.4)	(2.0)	(2.0)	(2.1)
Change in debt/GDP	7.6	13.0	7.6	11.2	6.4	2.0	2.4	3.0	3.5	3.6
Primary balance/GDP	(3.5)	(4.9)	(3.0)	(3.7)	(0.5)	1.8	1.6	1.0	1.0	0.9
Revenue/GDP	40.0	41.1	39.7	41.5	41.9	43.9	43.0	43.0	43.0	43.0
Expenditures/GDP	44.8	47.9	45.1	48.1	45.6	45.2	44.4	45.0	45.0	45.1
Interest /revenues	3.3	4.6	6.1	7.1	7.7	7.1	7.0	7.0	6.9	7.0
Debt/GDP	45.4	56.2	59.6	70.3	74.3	73.6	72.0	71.0	70.5	70.3
Debt/revenue	113.5	136.8	150.1	169.6	177.4	167.7	167.4	165.1	164.0	163.5
Net debt/GDP	40.4	50.7	52.1	61.7	66.5	66.4	65.2	64.6	64.4	64.5
Liquid assets/GDP	5.0	5.5	7.4	8.6	7.8	7.2	6.8	6.4	6.1	5.7
MONETARY INDICATORS (%)										
CPI growth	11.1	7.3	7.7	2.1	1.4	1.1	3.7	3.6	3.8	4.0
GDP deflator growth	9.6	6.3	5.4	2.7	2.7	1.1	2.8	2.8	3.0	3.0
Exchange rate, year-end (RSD/$)	80.87	86.18	83.13	99.46	111.25	117.14	117.14	119.00	121.00	123.00
Banks' claims on resident non-gov't sector growth	7.6	9.3	(4.6)	3.1	3.1	2.6	4.5	5.5	5.5	6.0
Banks' claims on resident non-gov't sector/GDP	51.5	53.5	47.2	48.2	48.1	47.5	47.0	46.8	46.7	46.8
Foreign currency share of claims by banks on residents	47.0	48.5	46.5	45.2	45.3	43.1	42.9	42.9	42.6	42.9
Foreign currency share of residents' bank deposits	65.1	67.2	62.1	59.6	58.2	59.4	58.0	58.0	58.0	58.0
Real effective exchange rate growth	10.2	(6.9)	6.8	(2.2)	(5.1)	(1.3)	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. RSD--Serbian dinar. CPI--Consumer price index. N/A--Not applicable. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

RATINGS SCORE SNAPSHOT

Table 2

Republic of Serbia Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral

Economic assessment	Neutral
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Weakness
Monetary assessment	Weakness

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

RELATED CRITERIA AND RESEARCH

Related Criteria

Criteria - Governments - Sovereigns: Sovereign Rating Methodology (/en_EU/web/guest/article/-/view/sourceId/8950072) - December 23,2014

General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments (/en_EU/web/guest/article/-/view/sourceId/5402435) - May 18,2009

General Criteria: Use Of CreditWatch And Outlooks (/en_EU/web/guest/article/-/view/sourceId/5612636) - September 14,2009

General Criteria: Methodology For Linking Long-Term And Short-Term Ratings (/en_EU/web/guest/article/-/view/sourceId/10011703) - April 07,2017

Related Research

Sovereign Ratings History (/en_EU/web/guest/article/-/view/sourceId/9636657amp;), May 5, 2017

Credit Trends: 2016 Sovereign Ratings Update: Outlook And CreditWatch Resolutions (/en_EU/web/guest/article/-/view/sourceId/10035183amp;), April 18, 2017

Global Sovereign Rating Trends: First-Quarter 2017 (/en_EU/web/guest/article/-/view/sourceId/10051075), April 10, 2017

Sovereign Risk Indicators (/en_EU/web/guest/article/-/view/sourceId/10051152amp;amp;), April 10, 2017. An interactive version is available at spratings.com/sri

2016 Annual Sovereign Default Study And Rating Transitions (/en_EU/web/guest/article/-/view/sourceId/10021871amp;amp;), April 3, 2017

Sovereign Debt 2017: CEE And CIS Commercial Borrowing To Increase By 5% To $171 Billion (/en_EU/web/guest/article/-/view/sourceId/9989452), February 23, 2017

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the flexibility and performance assessment had improved and that the debt assesment had deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

RATINGS LIST

	Rating To	From
Serbia (Republic of)		
Sovereign Credit Rating		
Foreign and Local Currency	BB-/Positive/B	BB-/Positive/B
Transfer & Convertibility Assessment	BB	BB
Senior Unsecured		
Foreign Currency	BB-	BB-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com (http://www.standardandpoors.com/) for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com (http://www.globalcreditportal.com/) and at spcapitaliq.com (http://www.spcapitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com (http://www.standardandpoors.com/). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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