Serbia Ratings Lowered To 'BB-' On Risks To Monetary Stability Amid External Pressures; Outlook Negative

Overview

Serbia's twin fiscal and external deficits have deteriorated in the first half of this year.

Weaker export performance and rising interest payments have seen the current account deteriorate, and we also estimate a 1.5% of GDP outflow of currency and deposit funding of foreign bank subsidiaries in the first five months, largely financed by drawing down reserves.

Legislative changes may see the Serbian central bank's effectiveness and independence reduced, undermining monetary stability.

We have therefore lowered our long-term foreign and local currency sovereign credit ratings on Serbia to 'BB-' from 'BB'. We are affirming the short-term foreign and local currency ratings at 'B'.

The negative outlook reflects our view that Serbia's twin fiscal and external deficits could create greater vulnerabilities, complicated by domestic institutional interference and financial spillovers from the eurozone.

Rating Action

On Aug. 7, 2012, Standard & Poor's Ratings Services lowered its long-term foreign and local currency sovereign credit ratings on the Republic of Serbia by one notch to 'BB-'. The outlook is negative.

The recovery rating is '4'. We have revised the transfer and convertibility (T&C) assessment to 'BB-'.

Rationale

The downgrade reflects our view that Serbia's new government has failed to quickly adopt policies that would promote confidence in its monetary regime and restore post-election fiscal stability. We believe this is exacerbating the already-significant internal and external pressures on the economy. Furthermore, recently adopted legislation will, in our view, weaken the institutional independence of the National Bank of Serbia (NBS, or the central bank), which could lead to the politicization of monetary policy. We expect this legislation will add pressure to both the exchange rate and Serbia's foreign exchange reserves, with negative second-round effects on inflation and therefore the bank's price stability mandate. This comes at a time of considerable external uncertainty. We are, moreover, becoming increasingly concerned that the new government may not be prepared--amid a recession and very high unemployment--to prioritize sustainable public finances and balanced economic growth. As a result, we have lowered the long-term ratings by one notch.

We expect that another consequence of the new government's policy choices will be a likely delay in negotiations with the IMF, which we view as a key provider of policy guidance and liquidity support to Serbia. In February 2012, the IMF suspended its stand-by agreement (SBA) with Serbia in response to the previous government's relaxation of the fiscal stance. The pre-election fiscal slippage was pronounced on the expenditure side; wage and pension hikes were up 15% year-on-year, subsidies were up nearly 90%, and interest payments increased 36% year-on-year. We had previously expected that talks would resume

once a new government was formed and that, regardless of composition, it would prioritize fiscal consolidation and key structural reforms that had been committed to under the suspended 2011 SBA with the IMF. Last week's adoption of amendments to the law on the central bank, which establishes a parliament-appointed supervisory body, could also jeopardize EU relations if perceived to be curbing the independence of the central bank. Serbia received EU candidate status in March 2012, but a date for accession talks has not yet been set.

The new government assumed office on July 27, nearly three months after the May 6 parliamentary elections. The length of time to form government and initial indications about the timeline for resuming talks are outside our initial base-case assumptions. Without the SBA as a policy anchor, we are concerned that the government will fall short on adopting reforms to improve the economy's flexibility and reduce already-high current expenditures, which dominate the budget. In our opinion, a decision to run a looser fiscal policy would test Serbia's moderate debt-bearing capacity, and could constrain the government's access to commercial markets. We estimate that the budget gap this year will exceed 6% of GDP, and that public debt will reach 55% of GDP at year-end 2012, from 42% at end-2011, due in part to the effect of currency depreciation.

Serbia is a highly euroized economy. Foreign currency deposits make up nearly 80% of total deposits, and an estimated 70% of lending is in foreign currency. This exposes the economy to balance of payments pressures while significantly constraining monetary flexibility, given the weak transmission channel between domestic interest rates and local credit conditions. We believe that the liquidity situation could worsen; for 2012 we project the current account deficit will remain high at 8% of GDP. The current account widened by more than 30% in the first five months of the year, but we expect some improvement in the trade balance in the second half when the production of FIAT SpA (BB-/Stable/B) automobiles starts. We also believe exchange rate effects and financing constraints will help narrow the external imbalance.

Serbia's external financing needs are relatively high. We estimate gross external financing needs at about 100% of current account receipts. Contrary to our previous expectation that external financing needs would be covered by increasing net exports and strong FDI (Serbia had one of the highest FDI inflows in the region in 2011, the key source of its current account deficit financing), Serbia has experienced a net FDI outflow of $200 million in the first five months of 2012. We expect net FDI for the year at just 1% of GDP.

There are also some indications of capital outflows during first-half 2012. In particular, in the first five months we saw an increase in Serbian residents' currency and deposit assets abroad by an estimated €0.6 billion or just over 1.5% of 2012 GDP. While this partly reflects the NBS' decision (implemented in April and June) to increase the local currency portion of foreign exchange required reserves, it also indicates to us the weak willingness and capacity of parent banks to provide net foreign-exchange funding to their local subsidiaries. Serbia's private-sector external assets have been historically quite volatile; the recent outflow helped see the financial account shift from a substantial surplus in 2011 to a significant deficit of more than 4% of GDP on an annualized basis for 2012. The outflow of resident deposits came on top of a slight decline in interbank funding in the first five months of 2012. As a result, the current account deficit has largely been financed by drawing down reserves.

The NBS has sold €1.3 billion (11% of reserves) so far this year to defend the dinar, which has depreciated 16% against the U.S. dollar from the beginning of the year. We estimate that current account financing of close to $3 billion in 2012 will be funded by a further drawdown in reserves and modest FDI. Gross financing needs--including the current account, short-term debt, and amortization of long-term debt--is estimated at over $8 billion. We expect commercial banks to rollover short-term debt of about $1.6 billion; public sector external financing needs of close to $2 billion would likely be financed either by official funding through an IMF agreement or further declines in reserves.

Outlook

The negative outlook reflects our view that the balance of risks to the ratings on Serbia is to the downside, as Serbia's twin fiscal and external deficits could lead to increased vulnerabilities. Serbia's high external financing needs also make it susceptible to shocks from the eurozone.

We could lower the ratings if we see deterioration of the fiscal position, or reversals on past commitments to structural reform in Serbia's labor and product markets that we believe could enhance growth prospects over the longer term. In light of the liquidity constraints inherent in a euroized economy operating sizable external deficits, we view some balance of payments support as a major policy anchor. For this reason, we would view the successful negotiation of a new fiscal consolidation and reform program with the IMF as contributing to rating stabilizing at the current level.

Source: Standard & Poor's.