

Serbia Outlook Revised To Positive On Strong Economic Growth, Strengthening External Metrics; 'BB+/B' Ratings Affirmed

Overview

- We expect Serbia's real GDP will exceed its pre-pandemic GDP by 6% by year-end 2021 and growth will settle at about 3.5% annually over the medium term.
- The economic rebound will make it easier for authorities to consolidate public finances over the next few years, curbing increases in government debt.
- Stronger external buffers amid resilient and increasingly diversified net foreign direct investment (FDI) should help Serbia to mitigate possible balance of payments risks.
- We have therefore revised our outlook on Serbia to positive from stable and affirmed the 'BB+/B' foreign and local currency ratings.

Rating Action

On Dec. 10, 2021, S&P Global Ratings revised its outlook on Serbia to positive from stable. At the same time, we affirmed the 'BB+/B' long- and short-term foreign and local currency sovereign credit ratings on the sovereign.

Outlook

The positive outlook reflects our view that Serbia's growth perspective should remain broadly resilient to the adverse effects of the pandemic's ongoing wave amid prudent macroeconomic policy settings. Absent a substantial deterioration in epidemiological conditions, we expect Serbia to achieve relatively high and balanced growth rates in the medium term. Coupled with the new (albeit unfunded) policy coordination arrangement with the IMF, this should support the government's efforts to consolidate public finances and stabilize the public debt burden. At the same time, high net FDI inflows should continue to overfund Serbia's current account deficits (CADs) and help to contain external debt and keep Serbia's foreign exchange (FX) reserve position strong.

Upside scenario

We could raise our rating on Serbia in the next 12 months should higher FDI inflows or lower CADs than we currently project further bolster the country's buffers against external pressures. We could also raise the rating if fiscal consolidation exceeded our expectations, putting net government debt as a share of GDP on a firm downward trend. Lastly, we could raise the rating if the country sustained higher real GDP growth rates over the medium term than we project, for example because of stronger public and private investment activity.

Downside scenario

We could revise the outlook to stable if Serbia's growth prospects proved to be weaker than forecast, derailing the government's fiscal consolidation plans and pushing public debt up. Similarly, we could revise the outlook to stable if weaker balance of payments performance put pressure on FX reserves or resulted in the buildup of external debt.

Rationale

Our rating on Serbia is supported by the sovereign's moderate public debt and a credible monetary policy framework. The rating is constrained by the country's relatively weak institutional settings, comparatively low economic wealth levels, a sizable net external liability position, and the continued extensive use of euros in the economy.

Institutional and economic profile: Less stringent lockdown restrictions and strong policy support have supported a strong domestic demand-driven recovery

- We expect Serbia's economy will expand by about 7% in 2021 and by over 4% in 2022, following only a shallow contraction last year.
- Domestic demand, specifically public investments and private consumption, will remain an important growth driver.
- It remains uncertain whether next year's elections will interrupt the trend of concentration of political power.

Throughout 2021 Serbia's economy has been recovering strongly and we now expect real GDP to expand by 7% for the full year. This rebound follows an only modest contraction of 1% in 2020, which means that Serbia's economy achieved its pre-pandemic GDP levels much quicker than most other countries.

There are several factors explaining this strong performance:

- Containment measures have been less stringent during the pandemic and a fast vaccination rollout meant they could be lifted earlier than elsewhere.
- Fiscal and monetary policy support was effective in cushioning the effects of the pandemic, particularly regarding the labor market.

- Sectors more affected by the pandemic, such as hospitality and tourism, are less relevant for Serbia's economy, while more important sectors, such as manufacturing and construction, were either not overly affected by the pandemic or benefited from high government investments.

These factors contributed to buoyant domestic demand this year, predominantly in the form of private consumption and public investments, seen in Serbia's construction sector expanding by almost 16% in the first nine months of 2021 in real terms.

Still, as elsewhere, risks relating to the pandemic remain. Although Serbia had a strong initial start to its vaccination campaign, the number of vaccinated people started to stagnate around the midyear and currently, less than 50% of the population is fully vaccinated. However, we believe that even if the pandemic resurged more strongly than expected, its economic impact would be more limited than in 2020. The economy has effectively adapted to the pandemic, and so lockdown measures, if any, will likely be more targeted and selective than previously. However, these risks could affect not just domestic demand, but also external demand for Serbia's exports, given that the economy is far more open than it was heading into the global financial crisis more than a decade ago. Exports now constitute about half of overall economic output, compared with less than a third in 2007.

Serbia's economic resilience to the pandemic so far is also the reason why we believe real GDP growth will exceed 4% in 2022. External and domestic demand will remain strong, with the latter also due to high government investments. Even though Serbia's long-term growth potential is hampered by several structural bottlenecks, we consider there is a good chance Serbia could exceed our 3.5% medium-term growth forecast. On the one hand, the current public infrastructure investments, for example in transportation, energy, and utilities, could boost Serbia's productivity more strongly than we expect. Government investments, at over 7% of GDP, are twice as high as they were only six years ago. On the other hand, Serbia's labor market still has room to grow, given relatively high unemployment and despite what we generally consider an adverse demographic profile due to aging population and net emigration.

The last election, in June 2020, saw the victory of the incumbent Serbian Progressive Party, which won three-quarters of the seats in parliament. The elections were overshadowed by the boycott by several main opposition parties and low voter turnout. This prompted President Aleksandar Vucic to call general elections for April 2022. We believe any new government will also likely try to advance reforms anchored by the recently signed nonfinancing Policy Coordination Instrument with the IMF, which predominantly aims to strengthen tax administration and the management of fiscal risks, tackle the informal economy, and develop capital markets.

At the same time, we continue to believe that the ongoing centralization of the institutional setup could undermine long-term policy predictability. This could, in turn, lead to flagging investor confidence. We also think that slowing the emigration of Serbia's most educated by creating adequate jobs across skill levels will remain an important test for subsequent administrations. Furthermore, relations between Serbia

and Kosovo remain contentious. A broader normalization of relations between the two, a prerequisite for Serbia's EU accession, is likely to remain a long-term challenge, in our opinion.

Flexibility and performance profile: Fiscal and external pressures proved more manageable during the pandemic compared to previous episodes of stress

- We expect fiscal deficits will narrow, whereas government funding costs will remain contained.
- Serbia's CADs will be covered by net FDI inflows over the next few years.
- FX reserves are at record highs, despite interventions by the National Bank of Serbia (NBS) to preserve the dinar's stability.

Due to the renewed extension of support measures and a stronger-than-expected economic recovery, we expect a fiscal deficit of around 5% of GDP for 2021. This is mostly a result of strong tax revenue growth and despite a significant third fiscal stimulus package, which included additional stimulus worth around 4% of GDP in the form of additional transfers to citizens, business support, and investment spending. We believe the fiscal deficit will begin to narrow in 2022 as fiscal support measures are withdrawn. Political considerations ahead of the April 2022 elections could slow the pace of consolidation, but we believe that high nominal GDP growth should mitigate these risks. More broadly, we expect the government will likely revert to its pre-pandemic conservative fiscal management, which was characterized by tight spending control and narrow deficits. However, the authorities intend to continue increasing capital spending to close the infrastructure gap while aiming to guide public finances toward balance over the next five years, amid broader economic reforms.

Given the improved fiscal outlook, we believe public debt, net of liquid government assets, will stabilize over the next few years, at slightly below 50% of GDP. In gross terms, general government debt will decrease to about 54% of GDP from about 58% because the government will reduce some of its ample liquid assets that it accumulated over the past months as a cash buffer. Current financing conditions have been favorable, and the government has been able to finance itself in international and domestic markets at very favorable rates, pushing down the effective interest rate. In addition, the government plans to monetize this year's additional allocation of IMF Special Drawing Rights (SDR) in 2022, close to \$880 million (in part or in total), rather than issue debt in international markets. This will create a long-term financial obligation of the government toward the IMF at a marginal interest cost. Still, almost 70% of government debt is denominated in FX, making it vulnerable to exchange-rate volatility. Furthermore, the debt of Serbia's state-owned enterprises has been consolidated under total government debt, which reduces further contingent liabilities from this source, although the restructuring of state-owned enterprises has yielded only modest success so far.

Serbia's external vulnerabilities are significantly lower than they were a decade ago, which was a stabilizing factor during the pandemic. Serbia has diminished its reliance on more volatile portfolio inflows compared with the era after the financial crisis, when these flows were the dominant source of financing for its large twin deficits. FDI--predominantly in tradeable sectors--has fully financed Serbia's current account deficits in recent years and we expect this trend to continue. This foreign investment over the past decade has also rushed into Serbia's manufacturing sector, strengthening and diversifying export receipts. These inflows have also aided the NBS' efforts to augment its FX reserve position.

Similar to fiscal policy, monetary policy support from the NBS was quickly deployed at the start of the pandemic. The NBS cut the key policy rate and increased the provision of liquidity to the banking sector via swap lines and repurchase agreements (repos). The NBS also stepped up FX-market intervention over the past two years, both selling and buying FX, to stabilize the dinar. Reserve accumulation continued, nevertheless, and the NBS' FX reserves stand at near record highs, at €16.3 billion (\$18.5 billion) at the end of October 2021. We estimate reserves (net of the required reserves banks maintain with the NBS against their domestic FX liabilities) will cover more than four months of current account payments on average through our forecast to 2024.

Headline price pressures have recently risen in line with global trends, which has prompted the NBS to start tightening monetary conditions via raising the average repo rate. At the same time, in contrast with regional peers, core inflation has remained within the NBS's target thanks to the stable exchange rate, but also thanks to broadly anchored inflation expectations on the back of the institution's effective efforts to keep low and stable inflation over the last seven years. In October, headline inflation stood at 6.6%, mainly driven by food and energy prices. We expect average inflation of 4% for full-year 2021, with only moderate increases in core price growth until the year-end and 3%-4% growth in 2022. This could mean that headline inflation could converge back to the NBS' target tolerance band of 3% plus or minus 1.5% fairly quickly in the second half of 2022 as prices of food and energy normalize.

The stability of the majority foreign-owned banking sector has improved, although the euroization of deposits and loans remains high at almost 60% of total stocks. The system's reported average capital adequacy ratio was 21.7% as of Sept. 30, 2021, and its loan-to-deposit ratio is strong, at slightly under 90%. The sector remains profitable, although returns have declined, and supportive of economic growth. Nonperforming loans stand at 3.6% of the total and continue to decline from the peak of 22% in 2015, although we believe that some asset-quality deterioration is likely when official forbearance and support measures are wound down. The sale of Serbia's third-largest lender, the previously state-owned Komercijalna Banka, to Slovenia's Nova Ljubljanska Banka (NLB), concluded in 2020. NLB now owns 88% of the entity.