04-Oct-2024

Serbia Upgraded To 'BBB-/A-3' On Strong GDP Growth And Increased External Buffers; Outlook Stable

Overview

- Strong domestic demand, partly bolstered by government infrastructure spending related to Expo Belgrade 2027 (Expo 2027), leads us to project Serbia's real GDP will expand by 4% in 2024 and in the next few years.
- We expect steady GDP growth and prudent policymaking will help Serbia to contain fiscal pressures and keep public debt levels moderate.
- Stronger external buffers, alongside ample and increasingly diversified net foreign direct investment (FDI), will cushion against potential external shocks.
- We raised our long-term sovereign credit rating on Serbia to 'BBB-' from 'BB+'. The outlook is stable.

Rating Action

On Oct. 4, 2024, S&P Global Ratings raised its long-term foreign and local currency sovereign credit ratings on Serbia to 'BBB-' from 'BB+'. At the same time, we raised our short-term foreign and local currency sovereign credit ratings to 'A-3' from 'B'. The outlook is stable.

We also revised Serbia's transfer & convertibility assessment to 'BBB' from 'BBB-'.

Outlook

The stable outlook reflects the balance between risks from protracted weakness in Serbia's key trading partners in the EU, like Germany and Italy, its heavy yet gradually decreasing dependence on Russian gas supplies, and regional geopolitical tensions, against the potential for the country's higher economic growth on the back of resilient domestic demand, as well as strengthening external buffers.

Upside scenario

We could upgrade Serbia if the country's GDP growth rates, and fiscal and external performance significantly outperform our projections. Improved governance standards, driven by structural reforms, could also serve as a potential catalyst for an upgrade. Ratings upside will likely be conditional on contained regional geopolitical risks.

Downside scenario

We could lower the ratings if an economic slowdown in Serbia's key EU trading partners, potential energy supply shocks, or heightened geopolitical tensions undermine the country's growth trajectory and exert pressure on its fiscal and balance of payments positions.

Rationale

The upgrade reflects Serbia's improved economic resilience against shocks on the back of strong macroeconomic management, which we expect to persist in the coming years. Compared with pre-pandemic levels, Serbia's real GDP has increased by 18%, foreign exchange reserves have doubled, and gross general government debt has dropped by over 2 percentage points to a moderate 48.4% of GDP. We believe that resilient domestic demand, accumulated fiscal and external buffers, and prudent fiscal and monetary policies anchored by arrangements with the International Monetary Fund (IMF) should allow Serbia to contain ongoing weakness in the eurozone and withstand possible future shocks.

Our ratings on Serbia are supported by the country's strong growth and FDI prospects, moderate public debt, and a credible macroeconomic policy framework. The ratings are constrained, however, by the country's relatively weak institutional framework, comparatively low GDP per capita, a still-sizable net external liability position, and high euroization in the economy.

Institutional and economic profile: Serbia's growth prospects remain solid due to strong consumer demand and investment related to Expo 2027

- We have revised upward our growth forecast to 3.9% for this year, from 3.3% at our previous review in April, driven by strong consumer spending as well as increased government spending linked to preparations for Expo 2027.
- Tensions with Kosovo remain elevated due to the dismantling of ethnic-Serbian parallel institutions and the removal of the Serbian dinar from circulation in Northern Kosovo. These tensions are expected to remain heightened until at least February 2025, when elections in Kosovo take place.
- Serbia's EU accession process will remain slow and challenging; it largely depends on an improvement in relations with Kosovo and Serbia's willingness to align with EU sanctions against Russia.

Despite weak economic growth in Serbia's key trading partners, stronger-than-expected domestic demand has led us to revise our real GDP growth forecast this year to 3.9%, up from the previous estimate of 3.3%. Growth will also be supported by household consumption on the back of easing inflation, wage increases, looser financial conditions, as well as increased government investment related to Expo 2027. We expect net exports to continue to drag on growth, primarily due to the rise in imports associated with Serbia's accelerating investment cycle.

We expect Serbia to post real GDP growth of 4%, on average, beyond 2024 thanks to the strength of domestic demand, recovering growth in key trading partners, and sound macroeconomic policies. However, vulnerabilities could still arise from external factors, for example the possible protracted economic weakness in the EU, particularly Germany and Italy, which absorbs about 65% of Serbia's exports. Another risk stems from Serbia's high dependence on Russian gas supplied via the Balkan Stream Pipeline. To mitigate energy risks, the Serbia-Bulgaria gas interconnector, launched in December 2023, will allow for 0.4 billion cubic meters of Azeri gas annually, covering part of Serbia's 3 billion cubic meters of yearly gas needs.

Parliamentary elections held in December 2023 saw the ruling Serbian Progressive Party (SNS) coalition achieve a strong victory, securing 48% of the vote and expanding its majority by nine seats to 129 out of a total of 250. The newly formed government has maintained policy continuity, focusing on reforms anchored by the ongoing program with the IMF. This program centers around preserving fiscal and macroeconomic stability, but also seeks to address structural weaknesses, particularly in Serbia's state-owned enterprises, especially in the energy sector.

That said, the increasing centralization of government decision-making that has taken place in the past few years could undermine long-term policy predictability. This increasing concentration of power within the government could pose risks to investor confidence, as it might reduce transparency and create uncertainties regarding the stability and consistency of the reform process in the years ahead.

Serbia's aspirations for EU membership could strengthen institutional checks and balances, yet the accession process is likely to remain protracted and complex. Since gaining EU candidate status in 2012, Serbia has made limited progress, having provisionally closed only two of the 35 chapters of the Acquis Communautaire. This underscores the significant reforms still required by the EU. Like other candidate countries, Serbia faces challenges such as improving the rule of law. However, it also contends with specific obstacles, including the normalization of relations with Kosovo and aligning its foreign policy with the EU, particularly on sensitive issues like Russia. These unique factors could further complicate Serbia's path to EU integration.

Serbia and Kosovo have made limited progress on the March 2023 Ohrid Agreement, which seeks to normalize relations between the two countries. Key provisions include mutual recognition of documents, establishment of permanent missions, and forming an ethnic Serb-dominated Association of Municipalities in Northern Kosovo. However, recent actions such as Kosovo's removal of the Serbian dinar in Northern Kosovo and the closure of five ethnic-Serbian parallel institutions have heightened tensions. These moves have strained relations further, casting doubt on the agreement's implementation, especially with parliamentary elections in Kosovo set for February 2025, which could further delay meaningful breakthroughs.

Flexibility and performance profile: Ambitious capital expenditure targets will increase fiscal pressures, but these will remain manageable

- The Serbian government has revised its 2024 budget deficit target upward to 2.9% of GDP from 2.4% for 2023, with the additional spending expected to be financed through the partial depletion of currently high cash reserves.
- We project the current account deficit to widen to 4.3% of GDP in 2024, from 2.4% last year, driven by higher defence and investment-related imports.
- FDI inflows will continue playing a key role in financing the current account deficit, which will help keep the central bank's foreign exchange reserves high.

The Serbian government recently revised upward its 2024 budget deficit to 2.9% of GDP from 2.2% in 2023. Both revenue and expenditure have been revised upward. The higher revenue reflects stronger-than-expected growth, while higher expenditure relates to targeted subsidies for farmers, increased childcare benefits, military spending, and higher capital expenditures linked to Expo 2027. The government plans to finance the additional spending by tapping into its high cash buffers (monthly in the form of the deposits, equivalent to 12% of GDP in July). Based on its track record in the past few years, we think Serbia could outperform the government deficit target, with the deficit coming in below 2.9% of GDP.

Looking ahead, we nevertheless anticipate wider fiscal deficits due to substantial government investments related to Expo 2027 and other capital expenditure. Serbia is allocating approximately €17.8 billion, roughly 25% of GDP, to this project over the next few years, prompting a temporary freeze of fiscal rules. These funds will primarily support infrastructure development, including in transport and energy, such as gas and heating networks. As a result, we expect fiscal deficits to average 2.4% of GDP from 2025-2027. The government is also discussing a new draft fiscal strategy, which apart from higher infrastructure spending will also reflect defence spending commitments, such as a €2.7 billion purchase of 12 fighter jets from France. Despite these pressures, we expect conservative fiscal management and robust nominal GDP growth to keep the government debt (currently at 48.4% of GDP) on the declining path. We understand that the updated medium-term fiscal path has been endorsed by the IMF.

Over 70% of Serbia's public debt is denominated in foreign currencies, which makes it vulnerable to exchange rate fluctuations. While the sustained stability of the dinar and hedging strategies involving the euro and U.S. dollar help mitigate some of this risk, any major shifts in the currency markets could increase debt servicing costs.

Despite past external shocks, the country's external profile has steadily improved, resulting from its success in deepening integration into European supply chains through FDI in export-oriented sectors, including manufacturing. Foreign investors have been taking advantage of Serbia's productive and relatively low-cost labor, but also its track record of preserving macroeconomic and financial stability. Over the past 10 years, total exports have more than tripled to the equivalent of over $45 billion (around 60% of GDP)--among the strongest performance in the region. Resilient and increasingly diversified net FDI inflows have overfunded the current account deficits since mid-2010s, allowing Serbia to downsize its net external leverage substantially.

Increased consumer demand and rising investment-related imports are set to exert pressure on Serbia's trade balance, leading us to forecast a widening of the current account deficit to 4.3% of GDP in 2024, up from 2.4% the previous year. Over 2025-2027, we expect the current account deficit to remain elevated at around 5% of GDP. However, this will likely be financed by sustained inflows of FDI, which have been instrumental in expanding and diversifying Serbia's export base. The net FDI inflows have also bolstered Serbia's foreign exchange reserves, which grew by 21% year on year, reaching €28.2 billion (equivalent to $31.5 billion) by August 2024. These reserves provide five months of current account payment cover. Looking ahead, we expect reserves to remain relatively stable, underpinned by continued net FDI inflows. However, risks persists, particularly due to global economic conditions that could impact FDI inflows and trade.

Headline inflation has generally been falling, easing to 4.3% in August from 11.5% in the same period last year on abating food and energy price inflation, the high base effect, and past monetary tightening. However, recent data indicates rising costs in services, industrial goods, and processed foods, contributing to some inflationary momentum. Additionally, core inflation has been edging higher, suggesting persistent underlying price increases. Looking ahead, we foresee additional upward movement in headline inflation, particularly as the recent drought is likely to drive food costs higher. Consequently, we expect headline inflation to average 4.6% this year, remaining within the National Bank of Serbia's (NBS)'s target range of 3.0%, plus or minus 1.5% in the second half of 2024 and beyond. While we expect the NBS to continue cautiously lowering interest rates, the central bank will likely remain careful, making future rate decisions based on evolving inflation trends and broader economic conditions.

We assess that financial stability risks in Serbia will remain low, supported by a well-capitalized, profitable, domestic deposits funded and a liquid banking system. As of the first quarter, the system's regulatory Tier 1 capital to risk-weighted assets stood at 19.5%, and the nonperforming loan ratio remained at a historical low of 2.7% in August, even amid economic challenges in 2023. Despite these strengths, high euroization persists, with more than 50% of total loans and deposits denominated in euros, posing vulnerability to exchange rate fluctuations. However, this risk is mitigated by the NBS' strong commitment to relative exchange rate stability.

The NBS has also initiated draft discussions on capping interest rates on both existing and new loans. While the law is in its early stages, banks have raised concerns that such measures could impact their profitability and lending appetite. On the other hand, some financial institutions have faced criticism for charging excessive fees, prompting the regulatory review. Despite these emerging regulatory changes, we believe that the risks of contingent fiscal liabilities from the banking sector remain contained.

Source: Standard & Poor's