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# Fitch and S&P upgrade Serbia's sovereign credit ratings on improving fiscal metrics

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- In line with our expectations, S&P upgraded on December 15th its long-term foreign and local currency sovereign credit ratings on Serbia at "BB" from "BB-", with stable outlook and affirmed the "B" short-term foreign and local currency sovereign credit ratings. We had recently argued that such a development was to be expected as S&P had noted earlier in the year that there was an increased upgrade likelihood over the next 6-12 months if fiscal developments exceed the agency's expectations, while there has been an ongoing improvement in government finances so far this year. Behind its decision, the agency noted "stronger fiscal metrics, underpinned by years of cost-containing efforts and revenue overperformance, amid steady economic recovery and contained current account deficits", while the stable outlook indicates "balanced risks to the ratings over the next 12 months."

- In more detail, S&P highlighted that, despite this year's economic slowdown, the general government deficits are likely to come in at decade lows, the prospect for fiscal slippages has reduced in view of a conservative 2018 budget draft and "some progress in downsizing contingent risks coming from state-owned enterprises (SOEs)", public debt has embarked on a downward path thanks to fiscal consolidation and the country's external performance has sustainably improved.

- The agency also noted that despite this year's expected deceleration in economic activity, which primarily stems from one-off factors such as adverse weather conditions, investments and consumption will likely support growth in the medium-term. It also expressed belief for policy continuity and fiscal discipline, driven by the EU accession process. Nevertheless, it warned about the "slow pace of structural reforms" which obstructs a swifter income convergence with the EU.

- Among the factors constraining Serbia's ratings, S&P cited low wealth levels, a high general government debt burden – mostly denominated in FX – limited monetary policy flexibility - primarily stemming from the banking sector's high level of euro-ization - and a sizeable – albeit declining – stock of non-performing loans (NPLs).

- In a similar move on Friday, Fitch also revised upwards Serbia's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BB' with a Stable Outlook. The agency acknowledged improving public finances supported by ongoing fiscal over-performance and expressed expectations for the fiscal consolidation to continue in 2018-19, "leading to smaller general government deficits relative to 'BB' peers."

- On this front, it added that an estimated 6% of GDP structural budget adjustment has been achieved since 2014, thanks to strong revenue collection and constrained expenditure on wages and pensions, forecasting a fiscal surplus of 0.5% of GDP in 2017, the first since 2005. Among the factors behind its latest upgrade decision the agency also highlighted the improvement in public debt, which it anticipates to further decline to 63.6% of GDP in 2017, 62.1% in 2018 and 60.6% in 2019 from a peak of 74.6% in 2015. Fitch also cited improving external finances and penciled in a pick-up in economic activity to 3.0% in 2018 and 3.3% in 2019 from an expected 1.9% reading in 2017, "supported by continuing strong domestic demand, a favourable cyclical environment, and continued FDI in the tradable sector to support export growth." Additionally, it acknowledged that banking sector conditions remain sound.

- Indeed, Serbia's macroeconomic fundamentals have improved a lot over the last three years. The economy has recovered from a triple-dip recession in 2009-2014, with economic activity having returned to positive growth readings from 2015 onwards. Last year's real

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GDP growth reached an eight-year high of 2.8%, while this year's slowdown towards 2.0% is largely attributed to temporary factors with the recovery expected to resume in 2018 on strong private consumption and investments. External imbalances have also improved over the last few years, with the current account deficit having eased towards a 14-year low of 4% of GDP from a peak of 21% in 2008. Furthermore, inflation has largely remained within or below the Central Bank's target since 2013.

- On the fiscal front solid budget execution has been the highlight of Serbia's macroeconomic picture thus far in 2017. The fiscal surplus in the first 10 months of the year totaled RSD 94bn, with this figure coming mostly from the revenue side despite slower than anticipated economic activity. This compared with a deficit of RSD 5.4bn recorded over the same period in 2016. In our view, a surplus around 0.5% to 0.7% of GDP is likely to be recorded this year, the first since 2005 when privatization proceeds used to be in the area of billions of euros. Additionally, public debt declined to 71.9% in 2016, easing further to 64.9% of GDP as of October this year from a 14-year peak of 74.7% in 2015. With no further austerity measures needed, some cautious fiscal expansion is penciled in for next year. The parliament adopted last week the 2018 budget, envisioning consumption stimulation, continuation of implementation of fiscal consolidation measures and a further decrease in public debt. The new budget reportedly takes into account bonuses for employees in the security sector, such as intelligence, police and army officers, salaries increases of public sector and administration employees between 5 – 10%, as well as an increase of 5% in pensions. Meanwhile, the fiscal deficit target is at 0.6% of GDP at RSD 28.4bn (~€240mn), while GDP growth is assumed at 3.5%, in line with the IMF's forecast, and inflation is seen at 2.7%, within the Central Bank target of 3 +/-1.5% .

- All in all, following a wave of rating downgrades in 2012-2014, all three major rating agencies have acknowledged the ongoing improvement in Serbia's domestic macroeconomic fundamentals witnessed over the last three years. Taking into account Friday's upgrades the long-term ratings of Fitch and S&P on Serbia are currently one notch above that of Moody's and two below investment grade. Moody's last upgraded Serbia's ratings in March, in a much anticipated move which came on the back of significant fiscal consolidation over the last couple of years and recent implementation of structural reforms that increased the resilience of the country's economy. Given that government finances continue to improve, external imbalances narrow further and economic activity picks up pace, new upgrades are possible in the months ahead.

**Figure 1**
**Serbia has emerged from a triple dip recession in 2009-2014; this year's slowdown to prove temporary**

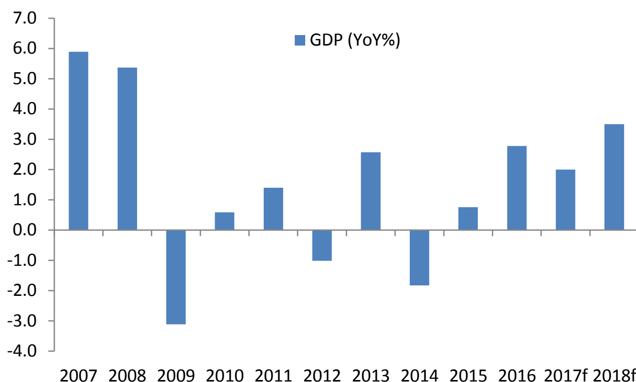
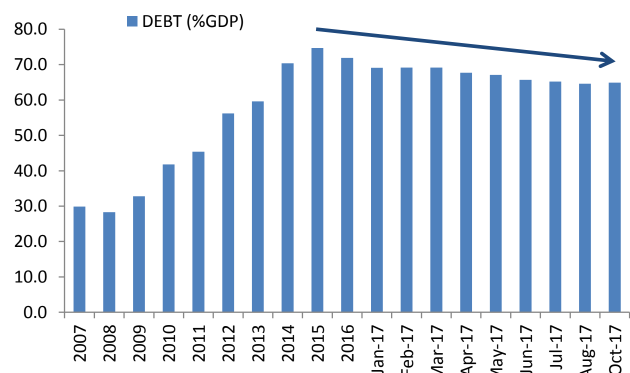



**Figure 2**
**Public debt on a declining mode since reaching a peak in 2015**




Source: National Statistics, IMF, Eurobank Research

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