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REGIONAL ECONOMICS & MARKET STRATEGY FOCUS NOTE

Eurobank

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SERBIA
Moody's upgrade on the cards on improving macroeconomic fundamentals

- Moody's is scheduled to review Serbia's sovereign credit rating later on Friday. In our view, an upgrade in the long term foreign currency sovereign rating today appears likely. Domestic macroeconomic fundamentals have notably improved over the last couple of years thanks to enhanced domestic political stability, improvement of investor sentiment on the back of an IMF policy anchor, substantial fiscal consolidation and monetary easing, improving credit dynamics and labor market conditions as well as narrowing external imbalances.

- In our recent Trip Notes (https://www.eurobank.gr/Uploads/Reports/EMERGING_MARKETS_SFR_201610.pdf), we made an extensive analysis on the progress of the Serbian economy. After several years of struggling with recession and stagnation, the Serbian economy has embarked on a virtuous cycle. Economic activity has embarked since last year on a recovery mode after the flood-induced recession in 2014 (Figure 1). Private investment and net exports have been the main contributors to real GDP growth so far this year, with domestic consumption also showing signs of recovery. Full year growth is projected at 2.7% in 2016. Prospects for 2017 are even more encouraging. According to official forecasts, GDP growth is expected to accelerate further to 2.8%-3.0% in 2017, as private expenditure is anticipated to further strengthen, while there is potential in the medium-term for the country to prove a regional outperformer.

- Serbia ranks among those few economies in the region that have accomplished to reverse the declining trend in the investment expenditure to GDP ratio. This is an important development supporting optimism for the sustainability of Serbia's medium-term growth performance. The said ratio is projected to increase to 18.3% of GDP in 2016, from levels around 17.5% in the prior two years and a pre-crisis high of 30.3% reached in 2008. The main driver behind this improving performance is increased inward foreign direct investment (FDI). Net FDI inflows have been incentivized by recent improvements in the domestic business environment as well as generous subsidies scheme offered to foreign investors. Net FDI inflows accounted for over 5% of GDP in 2015-16, a high ratio by both regional and international standards, providing more than full coverage to the current account deficit (159.3% of CA in Jan-Aug 2016). More importantly, in contrast to the pre-crisis era, more than one third of these FDI inflows are channeled to tradable sectors e.g. manufacturing.

- Following a structural adjustment equivalent to 2.6ppts of GDP in 2015, when the consolidated deficit was reduced to 3.7% of GDP from 6.7% in the prior year, the strong fiscal performance continued unabated in the first ten months of 2016. As of end-October, the general government budget had recorded a small surplus. A few guarantees payments to faltering SOE's to be executed in December, along with some seasonal expenses will bring the annual gap to around 1.8% to 2.0% of GDP for the whole of the year, some 2pp below the initial 2016 projections. This compares with a 6.6% of GDP shortfall, with this significant narrowing having been achieved via significant fiscal consolidation over the last two years. Initial forecasts on the 2017 budget as announced by the Ministry of Finance stipulate a yearly deficit of 1.7% of GDP; with a projected rise of output of ca. 3%, Serbia will gradually begin to reduce its public debt/GDP ratio, which had peaked this year, ahead of schedule agreed with the IMF (SBA programme projected a peak of debt/GDP in 2017). The Law on Budget 2017 should be approved in the Assembly in the first week of December.

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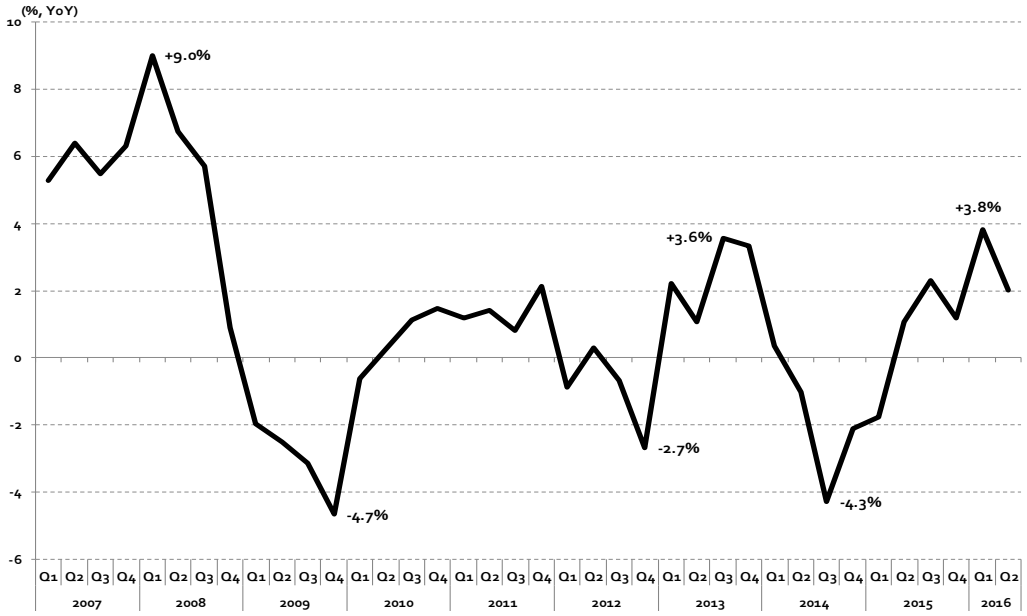
- At the same time, external imbalances have also been reduced a great deal as well in recent years. Exports have been rising faster than imports (10.1% vs. 5.7% YTD) thus reducing the trade deficit by 7.5% in the January-September period. Consequently the current account deficit will probably come in below 4.0% of GDP this year, vs. double digits in 2012, the smallest reading in a decade. Moreover, it is expected to be fully covered by FDIs.

- Following a wave of rating downgrades in 2012-2014, all three major rating agencies appear to be acknowledging over recent months the ongoing improvement in Serbia's domestic macroeconomic fundamentals witnessed over the last couple of years. S&P revised higher in January the country's outlook to Stable from Negative, while affirming its "BB-" rating in July 2016. Furthermore, Moody's changed its outlook on Serbia to Positive from Stable in mid-March, also affirming the country's "B1" rating. Fitch was the first agency to proceed with an upgrade on Serbia's sovereign rating, revising in June one notch higher its Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) to "BB-" from "B+" with Stable outlook. The corresponding ratings of both S&P and Fitch currently stand one notch higher that of Moody's, therefore an upgrade today by the latter could be expected, especially bearing in mind the aforementioned macroeconomic improvements, which became even more apparent in the second half of the current year. Provided that the current drive for structural reforms and fiscal consolidation is maintained, further credit rating moves should not be excluded in the foreseeable future.

Figure 1
Serbia has emerged from a triple dip recession in 2009-2014



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