Republic of Serbia Rating Outlook Revised To Negative Owing To Heightened Political Risks

Rationale

On March 11, 2008, Standard & Poor's Ratings Services revised its outlook on the Republic of Serbia to negative from stable, due to heightened political risk following the collapse of the Serbian government. At the same time, the long-term 'BB-' and short-term 'B' sovereign credit ratings were affirmed.

Prime Minister Vojislav Kostunica's 10-month-old government collapsed on March 10 after disagreements over the handling the political crisis caused by Kosovo's unilateral declaration of independence in February, which led to further disagreements over EU integration.

Early elections will be held on May 11, 2008, with the specter of a nationalistic government gaining power looming large. This would negatively affect Serbia's EU prospects, which have hitherto been a key supporting factor for its sovereign rating.

Whereas all relevant Serbian parties share the view that Kosovo's independence is "illegal", Mr. Kostunica's Democratic Party of Serbia (DSS) has been supportive of the nationalist Radical Party's initiative that would bring further EU integration to a halt. This includes signing the Stabilisation and Association Agreement (SAA) unless EU-members retract their diplomatic recognition of Kosovo.

The Kosovo-fallout is likely to dominate the election campaign. Outrage over the loss of Kosovo in the wider population may lead to a new government dominated by the radicals, who were traditionally the strongest parliamentary force. This in turn might be the harbinger of an isolationist policy stance, damaging prospects for economic reforms and the economic boost that would be gained by EU integration.

Standard & Poor's has previously stated that Kostunica's government, which had included President Boris Tadic's pro-European Democratic Party (DS) as a senior partner, had been inclined to internal rifts and was susceptible to a collapse before the end of its term. With the DSS unexpectedly aligning with the Radical Party on such a critical issue as policy towards Europe, a more fundamental change of post-electoral policies has now become more likely.

The government's collapse could lead to an unduly expansive fiscal approach and a renewed policy hiatus, similar to the 2007 general election. Furthermore, political risks will accentuate the risks associated with Serbia's external vulnerabilities. The current account deficit might reach 14% of GDP this year and, as privatizations are delayed and investor sentiment deteriorates, urgently needed foreign direct investment (FDI) may disappoint again (FDI coverage of the external deficit was only 25% in 2007). Intensified foreign borrowing, a loss of reserves, or a significant economic slowdown may result, despite strong economic growth in 2007 estimated at over 7% of GDP.

Outlook

The negative outlook reflects the growing risk that a government might emerge from the elections that would break with the current coalition's objective of pursuing EU membership. The emergence of a government halting economic reforms and discounting the economic and political benefits of EU membership would lead to a lowering of the sovereign ratings on Serbia, as would a further rise of external imbalances, a budgetary blow-out, or significant slippage in economic reforms.

Serbia's heightened political polarization could also sweep a reform-minded coalition to power, however. If tangible progress were made such that prospects for economic reform (in particular privatizations and corporate restructuring), rebalancing of the economy, and EU rapprochement advanced, the outlook for Serbia's competitiveness and creditworthiness would be revised back to stable.

In resolving the negative outlook, which is expected before year end, we will be led by actual policies following the election, in particular those related to economic reforms and EU integration, rather than rhetoric before the election.

Source: Standard & Poor's.